Index to Consolidated Appendix

In the Supreme Court
OF THE
United States

OCTOBER TERM, 1967

Nos. 760 and 781

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,
vs.
IRVING GORDON and MARGARET GORDON,
Respondents.
No. 760

On Writ of Certiorari to the United States Court of Appeals for the Second Circuit

OSCAR E. BAAN and EVELYN K. BAAN,
Petitioners,
vs.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.
No. 781

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

CONSOLIDATED APPENDIX

TAX COURT OF THE UNITED STATES

GENERAL DOCKET

Docket No. 3949-63

IRVING GORDON and MARGARET GORDON
(Husband and Wife)
411 West End Avenue
New York, New York *Petitioner,*

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Appearances for Petitioner:

Name Harry R. Horrow; Claude H. Hogan; Stephen J. Martin

Address (Pillsbury, Madison & Sutro) 225 Bush St., San Francisco 4, California

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Aug. 16, 1963—Petition Filed: Fee Paid; Served Aug. 19, 1963

Aug. 16, 1963—Petr's. Request for Trial at San Francisco, Calif., filed, Granted Aug. 19/63; Served Aug. 19, 1963

Oct. 18, 1963—Motion by resp. to extend time from Oct. 18, 1963 to November 4, 1963 to file Answer. Granted 10/21/63; Served Oct. 21, 1963

Nov. 4, 1963—Answer filed by Resp. Served Nov. 7, 1963

Dec. 19, 1963—Reply filed by Petrs. Served Dec. 30, 1963

Nov. 23, 1964—Joint Motion for consolidation of Dkts. 949-63 and 3949-63 for hearing in Washington, D. C. on Dec. 15, 1964 and for decision.

Nov. 23, 1964—Consolidated Stipulation of facts with exhibits filed (1) (with drawing, see transcript of hearing page 13)

Nov. 23, 1964—Ordered that motion is granted and cases are consolidated for trial and opinion and are calendared for trial Tuesday Dec. 15, 1964 Wash. D.C. Served Nov. 24, 1964

Dec. 15, 1964—Trial at Washington, D.C. by Judge Raum.
Consolidated Stip. of Facts with joint exhibits filed.
Orig. Briefs due March 15, 1965.
Reply Briefs due April 29, 1965.

Under Submission—Judge Raum

Dec. 18, 1964—Transcript of proceedings of Dec. 15, 1964 received.

Mar. 15, 1965—Motion by resp. for ext. of time from March 15, 1965, to March 29, 1965, in which to file Brief. Granted Mar. 16, 1965; Served Mar. 16, 1965

Mar. 15, 1965—Orig. Brief filed by petitioners. Served Mar. 29, 1965

Mar. 26, 1965—Orig. Brief filed by respondent. Served Mar. 29, 1965

Apr. 2, 1965—Joint Motion for leave to file Supplemental Stipulation of facts filed. Supplemental Stipulation lodged. Granted Apr. 5, 1965; Served Apr. 5, 1965

Apr. 2, 1965—Joint Motion to correct transcript. (Corrections attached.) Granted Apr. 5, 1965; Served Apr. 5, 1965

Apr. 5, 1965— Supp. Stip. of Facts filed.

May 12, 1965—Reply Brief filed by petitioners. Served May 20, 1965

May 13, 1965—Motion by resp. for extension of time to May 21, 1965 to file Reply Brief. Granted May 14, 1965; Served May 17, 1965

May 20, 1965—Reply Brief for Respondent filed. Served May 20, 1965

July 7, 1965—Motion by petr. for leave to file Supplemental Reply Brief filed. Supplemental Reply Brief lodged. Granted July 8, 1965; Served Jul. 9, 1965

July 8, 1965—Supplemental Reply Brief filed by petitioners. Served Jul. 9, 1965

Oct. 19, 1965—Findings of Fact and Opinion filed, Judge Raum. Decision will be entered under Rule 50. Served Oct. 19, 1965

Dec. 6, 1965—Agreed Computation filed.

Dec. 15, 1965—Decision entered, Judge Raum. Served Dec. 15, 1965

Appellate Proceedings

March 11, 1966—Petition for Review by U.S.C.A. Second Circuit, filed by Respondent. Served 3/11/66

Mar. 11, 1966—Notice of filing Petition for Review sent to counsel for Petrs. Served 3/11/66

March 17, 1966—Proof of service of petition for review filed.

March 18, 1966—Proof of service of petition for review from petrs. filed.

Mar. 23, 1966—Order extending time for filing record on review and docketing pet. for review to June 9, 1966. Served 3/23/66

Mar. 23, 1966—Notice to parties of ext. of Date for trans. of record, filed. Served 3/23/66

Apr. 5, 1966—Cross Petition for Review filed by Petrs.

Apr. 5, 1966—Notice of filing Cross Petition for review; proof of service by respondent thereon, filed. Served 4/6/66

Apr. 5, 1966—Order extending time for filing record and docketing petition for review to June 9, 1966, covering Cross Petition for Review. Served 4/6/66

Apr. 7, 1966—Notice of filing Cross Petition for Review; with proof of service by resp. thereon, filed by ptrs.

Apr. 14, 1966—Affidavit of service by mail of Cross Petition for Review filed by petrs.

TAX COURT OF THE UNITED STATES

GENERAL DOCKET

Docket No. 949-63

Oscar E. Baan and Evelyn K. Baan
15 Gordon Street
Sausalito, California *Petitioner,*

vs.

Commissioner of Internal Revenue,
Respondent.

Appearances for Petitioner:

	Harry R. Horrow, Esq.,
Name	Claude H. Hogan, Esq.,
	(Pillsbury, Madison & Sutro)
Address	225 Bush Street, San Francisco 4, California
	Stephen James Martin, Esq., ent. 4-1-63

Mar. 5, 1963—Petition Filed: Fee Paid—March 7, 1963. Served Mar. 7, 1963

Mar. 5, 1963—Request by Petrs. for trial at San Francisco, Calif. Granted Mar. 7, 1963; Served Mar. 7, 1963

Mar. 7, 1963—Filing Fee Received.

Apr. 1, 1963—Appearance of Stephen James Martin, Esq., filed. Served Apr. 2, 1963

Apr. 25, 1963—Answer filed by Resp. Served Apr. 26, 1963

Apr. 24, 1964—Motion by resp. for leave to file Amendment to Answer filed. Amendment to Answer lodged. Granted May 15, 1964; Served May 18, 1964

April 29, 1964—Notice of filing of motion by respondent for leave to file amendment to answer and hearing on May 27, 1964, Washington, D.C. if objections filed on or before May 13, 1964. Served Apr. 29, 1964

May 15, 1964—Amendment to Answer filed by resp. Served May 18, 1964

June 29, 1964—Reply filed by petitioners. Served June 30, 1964

Nov. 23, 1964—Joint Motion for consolidation of Dkts. 949-63 and 3949-63 for hearing in Washington, D.C. on Dec. 15, 1964, and for decision.

Nov. 23, 1964—Consolidated Stipulation of Facts with exhibits filed (1)

Nov. 23, 1964—Ordered that motion is granted and the cases are consolidated for trial and opinion and are calendared for trial on Tuesday, Dec. 15, 1964, Wash. D.C.

Dec. 15, 1964—Trial at Washington, D.C. by Judge Raum. Consolidated Stip. of Facts with joint exhibits filed.

Orig. Briefs due March 15, 1965.

Reply Briefs due April 29, 1965.

Dec. 18, 1964—Transcript of proceedings of Dec. 15, 1964 received.

Mar. 15, 1965—Motion by resp. for ext. of time from Mar. 15, 1965 to March 29, 1965 in which to file Brief. Granted Mar. 16, 1965; Served Mar. 16, 1965

Mar. 15, 1965—Orig. Brief filed by petitioner. Served Mar. 29, 1965

Mar. 26, 1965—Orig. Brief filed by respondent. Served Mar. 29, 1965

Apr. 2, 1965—Joint Motion for leave to file Supplemental Stipulation of facts filed. Supplemental Stipulation lodged. Granted Apr. 5, 1965; Served Apr. 5, 1965

Apr. 2, 1965—Joint Motion to correct transcript. (Corrections attached.) Granted Apr. 5, 1965; Served Apr. 5, 1965

Apr. 5, 1965—Supp. Stip. of Facts filed.

May 12, 1965—Reply Brief filed by petitioner. Served May 20, 1965

May 13, 1965—Motion by resp. for extension of time to May 21, 1965 to file Reply Brief. Granted May 14, 1965; Served May 17, 1965

May 29, 1965—Reply Brief for Respondent filed. Served May 20, 1965

July 7, 1965—Motion by petr. for leave to file Supplemental Reply Brief filed. Supplemental Reply Brief lodged. Granted July 8, 1965; Served July 9, 1965

July 8, 1965—Supplemental Reply Brief filed by petitioners. Served July 9, 1965

Oct. 19, 1965—Findings of Fact and Opinion filed, Judge Raum. Decision will be entered for the petitioners. Served Oct. 19, 1965

Oct. 20, 1965—Decision Entered, Judge Raum. Served Oct. 20, 1965

Jan. 13, 1966—Petition for Review by U.S.C.A. 9th Cir. filed by Respondent.

Jan. 13, 1966—Designation of Contents of Record on Review with Statement of Service thereon filed by Respondent.

Jan. 17, 1966—Order extending time for filing the record on review and docketing the petition for review to April 13, 1966. Served 1/18/66

Jan. 17, 1966—Notice, parties, of extension of date of transmission of record on review to April 13, 1966. Served 1/18/66

Jan. 25, 1966—Proof of service of petition for review from petrs. filed.

Jan. 25, 1966—Proof of service of petition for review from counsel for petrs. filed.

GENERAL DOCKET

UNITED STATES COURT OF APPEALS
for the Second Circuit

Case No. 30572

C.I.R. v. IRVING GORDON and MARGARET GORDON

Date	Filings—Proceedings
6- 3-66	Filed record (original papers of Tax Court)
6-30-66	Filed order extending time to file Commissioner's brief & appendix as both petitioner and respondent by 8-17-66; taxpayers brief & appendix as petitioners and respondent 45 days after; Commissioner's reply brief 30 days after taxpayers brief
8-15-66	Filed order extending time to file Commissioner's brief & appendix to 9-16-66
9- 6-66	Filed order extending time for CIR to file brief & appendix to 9-30-66; taxpayers brief & appendix to 11-14-66; CIR's reply brief to 12-14-66
10- 3-66	Filed notice of appearances (petitioner)
10 -3-66	Filed notice of appearances (respondent)
10- 6-66	Filed order extending time to file CIR brief & appendix to 10-13-66; taxpayers brief & appendix to 11-27-66; CIR's reply brief to 12-27-66
10-13-66	Filed appendix, (CIR)
10-13-66	Filed brief, (CIR)
11-18-66	Filed application and order granting leave to file taxpayer's brief not to exceed 55 pages
11-18-66	Filed appendix, taxpayer (Gordon)
11-18-66	Filed brief, taxpayer (Gordon)

Date	Filings—Proceedings
12-14-66	Filed reply brief (CIR)
12-14-66	Filed notice of appearances
12-14-66	Filed notice of appearances
1-24-67	Argument heard (by: Moore, Friendly, CJJ & Bryan, DJ)
7-26-67	Judgment Affirmed in Part; Reversed in Part, Moore, CJ
7-26-67	Dissenting in separate opinion, Friendly, CJ
7-26-67	Filed judgment
8-14-67	Issued Mandate (opinion & judgment)
8-25-67	Original record returned to Tax Court
9- 5-67	Filed receipt of return of original record to Tax Court
10-16-67	Received recalled original record from Tax Court
10-18-67	Certified original record exhibits and proceedings to Solicitor Gen. Washington, D.C.
10-25-67	Filed notice of filing of petition for writ of certiorari
11- 6-67	Filed receipt by Supreme Court of original record
1-22-68	Filed certified copy of order of Supreme Court granting petition for writ of certiorari

GENERAL DOCKET

UNITED STATES COURT OF APPEALS
for the Ninth Circuit

Case No. 20863

COMMISSIONER OF INTERNAL REVENUE

v.

OSCAR E. BAAN and EVELYN K. BAAN

Date	Filings—Proceedings
1966	
Apr. 6	—Filed certified typed record and docketed cause
June 16	—Filed appellants statement of points and designation of record
June 29	—Filed orig & three of respondents designation
Oct. 12	—Filed 20 Briefs for the Petitioner
Nov. 14	—Filed 20 Briefs for the Respondents
Dec. 5	—Filed 20 Petitioners Reply Brief
1967	
Feb. 7	—Argued and submitted to Hamley, Merrill & Ely
July 7	—Ordered opinion (Hamley) filed & Judgment filed & entered accd'ly
July 7	—Filed opinion. Reversed and remanded
July 7	—Filed and entered Judgment
Aug. 4	—Filed 20 respondents petition for rehearing
Aug. 15	—Filed order (Hamley Merrill & Ely) denying petition for rehearing & suggestion for rehearing en banc.
Aug. 22	—Filed motion & order (Hamley) staying issuance of Judgment to Sept. 20, 1967.
Sept. 5	—Issued certified copy of record to Clerk, SC, for writ of certiorari.

[159]*DOCKET ROOM
1963 Aug. 16
Tax Court
of the
United States

FILED
1963 Aug. 16
Tax Court
of the
United States

Tax Court of the United States

IRVING GORDON and MARGARET GORDON, Petitioners, vs. COMMISSIONER OF INTERNAL REVENUE, Respondent.	Docket No. 3949-63

PETITION

The above-named petitioners hereby petition for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency dated July 19, 1963, bearing symbols Form L-21, AU:R: 90D, and as a basis of their petition allege as follows:

1. The petitioners IRVING GORDON and MARGARET GORDON are individuals residing at 411 West End Avenue, New York City, New York. Petitioners, who are husband and wife, filed their joint Federal income tax return for the calendar year 1961 on a cash receipts and disbursements basis with the District Director of

*Figures in brackets refer to pages of the Record.

Internal Revenue for the Manhattan District of New York, at New York City, New York.

2. The date of mailing of the notice of deficiency on which this petition is based was July 19, 1963. A copy of [160] the notice of deficiency is attached, marked "Exhibit A."

3. The deficiency determined by the Commissioner is $895.10 in Federal income tax for the year 1961, the entire amount of which is in controversy.

4. The Commissioner erred in the determination of the deficiency in the following respects:

a. The Commissioner erred in determining that the receipt by petitioners of common stock of Pacific Northwest Bell Telephone Company (hereinafter "Northwest") upon the exercise of rights to purchase said stock received by petitioners as common shareholders of The Pacific Telephone and Telegraph Company (hereinafter "Pacific") resulted in a distribution of property taxable as a dividend under section 301 of the Internal Revenue Code of 1954 (hereinafter "Code") in the amount of the excess of the fair market value of the stock of Northwest at the time of the exercise of said rights over the amount paid by petitioners for said stock or in any amount.

b. The Commissioner erred in determining that the fair market value of the Northwest stock at the time of exercise by petitioners of rights received by them as common shareholders of Pacific to purchase such stock was $6,896.64 or any amount greater than $6,656.00.

c. The Commissioner erred in determining that petitioners received taxable gross income in the amount of

[161] $2,800.64 or in any amount in 1961, by reason of the receipt of common stock of Northwest by petitioners upon the exercise of rights received by them as common shareholders of Pacific.

d. The Commissioner erred in failing to determine that the receipt by petitioners in 1961 of common stock of Northwest upon the exercise by petitioners of rights received by them as common shareholders of Pacific, or the receipt by petitioners in 1961 of such rights, was in a distribution of stock of a controlled corporation under the provisions of section 355 of the Code, in respect of which no gain or loss was recognizable to, and no amount was includible in the income of petitioners.

e. In the event the Court does not find that the Commissioner erred as stated in paragraph 4.d. above, then in the alternative, the Commissioner erred in failing to determine that the distribution of property by reason of the exercise of rights to purchase Northwest stock in 1961 was a distribution in partial liquidation of Pacific within the provisions of section 346, which should be applied against the basis of petitioners' common stock of Pacific in respect to which such distribution was made, and thereby did not result in any taxable gain or income to petitioners in the year 1961.

f. As an additional alternative, in the event that this Court does not hold that the Commissioner erred as alleged in paragraphs 4.d. and 4.e. above, then the Commissioner erred in failing to determine that the distribution of property [162] resulting from the exercise by the petitioners of rights to purchase Northwest stock in 1961 was a distribution in connection with a reorganization

under section 368, which did not have the effect of the distribution of a dividend and did not give rise to any taxable gross income.

g. As an additional alternative, in the event this Court does not hold that the Commissioner erred as set forth in paragraphs d to f above, then the Commissioner erred in failing to determine that petitioners received shares of common stock in Northwest in redemption of a portion of their common stock interest in Pacific, in respect of which petitioners made a capital contribution to Pacific.

h. As a final alternative, the Commissioner erred in determining that the amount of dividend income of the petitioners from receipt of Northwest stock in 1961 was $2,800.64, or any amount greater than $2,560.00.

5. The facts on which the petitioners rely as the basis of this proceeding are as follows:

a. Throughout the year 1961, and at all times material herein, Pacific was a corporation, organized and existing under the laws of the State of California. Prior to July 1, 1961, it carried on telephone communications businesses in the States of California, Oregon, Washington and a northern portion of Idaho. Its wholly owned subsidiary, Bell Telephone Company of Nevada, at all times material herein, carried on telephone communications businesses in Nevada. During the year 1961, Pacific's capital [163] stock consisted of the following: 820,000 shares of six per cent cumulative preferred stock, par value $100 per share, entitled to seven votes per share held, of which 820,000 shares were issued and outstanding, with an aggregate par value of $82,000,000; and 105,000,000 shares of common stock par value $14-2/7 per share, entitled

to one vote per share held, of which 104,756,943 shares were issued and outstanding, with an aggregate par value of $1,496,527,844.

b. At all times during 1961, American Telephone and Telegraph Company (hereinafter "American") was a corporation organized and existing under the laws of the State of New York, and owned 90.25 per cent of the common stock and 78.17 per cent of the preferred stock of Pacific, representing 89.62 percent of the total voting power of Pacific. At all times herein American owned more than 80 per cent of the total voting power of the stock of Pacific. Pacific was a member of the affiliated group of which American was the common parent for the taxable year 1961.

c. During the year 1961, and at all times material herein, Pacific's taxable year was the calendar year and Pacific kept its books of account and filed its returns on the accrual method. Pacific kept its books of account in accordance with the rules and regulations of the Federal Communications Commission and the public utility regulatory agencies in each of the states in which it was engaged in business. In the consolidated Federal income tax [164] returns filed by American and its affiiliated members, including Pacific, all unrealized intercompany profits and losses arising from transactions between members of said affiliated group were eliminated.

d. For more than five years prior to July, 1961, the operations of Pacific in the states of Oregon, Washington and a northern portion of Idaho consisted of one or more telephone communications businesses which were separate from the telephone communications businesses operated

by Pacific in the State of California. At all times after June 30, 1961, the telephone communications businesses formerly conducted by Pacific in the states of Oregon, Washington and Idaho have been conducted in such states by Northwest. At all times after June 30, 1961, the telephone communications businesses formerly conducted by Pacific in the State of California have continued to be conducted in such state by Pacific.

e. On February 27, 1961, the board of directors of Pacific submitted to the shareholders of Pacific a Plan for Reorganization of Pacific (hereinafter "Plan"), to be considered at the annual meeting of the shareholders on March 24, 1961. The purposes of the plan were as follows:

(1) To divide the businesses and properties of Pacific between two corporations, one Pacific and the other a new corporation.

[165] (2) To have the businesses and properties in the states of Oregon, Washington and Idaho operated through a separate corporation to cope with the increasing magnitude and complexity of business operations.

(3) To bring top authority and management of each corporation closer to the communities served, to permit better recognition of the service needs of each community, more flexibility in dealing with customers, closer relations with employees, and better understanding and acceptance by the public.

(4) To put the new corporation as nearly as possible in the same situation with respect to capital structure, operations and profits as it would have been in if it had at all times conducted all operations of Pacific in the states of Oregon, Washington and Idaho.

(5) To confine the active management and operations of Pacific to the businesses and properties of Pacific in the State of California, so as to permit the management of Pacific to devote full attention to its expanding operations in the State of California.

(6) To raise additional capital required by Pacific for its operations in the State of California.

f. On March 24, 1961, the shareholders of Pacific duly approved and adopted the Plan described herein, subject [166] to consent and approval by the Federal Communications Commission and the regulatory agencies in each of the states of Idaho, Oregon and Washington.

g. Pursuant to the Plan the following took place:

(1) Northwest was organized under the laws of the State of Washington on March 27, 1961. Its authorized capital consisted of 50,000,000 shares of $11 par value common stock. On or about April 1, 1961, 10,000 shares of $11 par value common stock of Northwest were issued to Pacific for the payment of cash by Pacific of $110,000.

(2) As of June 30, 1961, all of the businesses and properties of Pacific in the States of Oregon, Washington and Idaho were transferred to Northwest in consideration for:

(a) the assumption by Northwest of operating liabilities, with certain exceptions, relating to the operations of Pacific in such states;

(b) the issuance to Pacific by Northwest of a promissory note payable on demand in the principal amount of $200,000,000 bearing interest at the rate of 4½% per cent per annum; and

(c) the issuance to Pacific by Northwest of an additional 30,450,000 shares of its $11 par value common stock, having an aggregate par value of $334,950,000.

(3) On September 29, 1961, Pacific issued to its [167] shareholders rights, evidenced by assignable warrants, to purchase 17,459,490 shares of the common stock of Northwest, constituting approximately 57 per cent of the total outstanding common shares of Northwest. Each shareholder of Pacific other than American, of record at the close of business on September 20, 1961, received one right for each common share of Pacific so held, and 7 rights for each perferred share of Pacific so held. Six such rights and the payment of $16 were required for the purchase of each share of common stock of Northwest. The time for exercise of said rights expired October 20, 1961. On or prior to said date, 17,446,031 shares of common stock of Northwest were purchased through the exercise of said rights. Such shares at the date of said exercise had an aggregate fair market value of $468,852,920. Pacific received by reason of said exercise of rights $279,136,496 in cash.

(4) It was contemplated that (i) Pacific would within approximately three years offer to its shareholders, by the same procedure as described above, all of the remaining common stock of Northwest held by it; (ii) American, by reason of its stock ownership in Pacific, would receive rights to purchase more than 80 per cent of the common stock of Northwest; and (iii) American would exercise all of the rights it received and would purchase all of the

common stock of Northwest it was entitled thereby to purchase. American exercised all the rights it received in 1961 and purchased all the common stock of Northwest which it was thereby entitled to purchase.

(5) The common stock of Northwest was listed on the [168] American Stock Exchange and on the Pacific Coast Stock Exchange and trading with respect to said shares commenced on September 13, 1961, on a when-issued basis. The rights were admitted to trading on the American Stock Exchange, and on the Pacific Coast Stock Exchange, and trading with respect to said rights commenced on September 13, 1961, on a when-issued basis.

h. By reason of the issuance of rights to purchase Northwest stock to Pacific shareholders, as set forth herein, and the exercise of such rights by said shareholders, there was no distribution of property by Pacific to its shareholders constituting a dividend or having the effect of a dividend, or essentially equivalent to a dividend, and the transaction whereby common stock of Northwest was transferred by Pacific to its shareholders as described herein was not used as a device for the distribution of earnings and profits of Pacific or Northwest, or both.

i. The adjusted basis to Pacific of the properties transferred by it to Northwest, as of June 30, 1961, exceeded the liabilities of Pacific assumed by Northwest in consideration for such transfer.

j. At all times during 1961 petitioners owned 1,540 shares of common stock of Pacific, and petitioners received under the Plan with respect to such shares 1,540

rights to purchase common stock of Northwest. On October 5, 1961, petitioners exercised all but 4 of said 1,540 rights issued to them, entitling them to purchase 256 shares of common stock of Northwest, and [169] paid $4,096 to Pacific. By reason of the exercise of said rights petitioners received 256 shares of common stock of Northwest from Pacific. On October 5, 1961, the fair market value of said 256 shares of common stock of Northwest acquired by petitioners was $6,656, rather than the amount of $6,896.64 determined by the Commissioner in the notice of deficiency dated July 19, 1963. The total cost of the 1,540 shares of common stock of Pacific with respect to which such rights were issued was $28,277.58. In their joint Federal income tax return filed petitioners did not include as income any amounts with respect to the exercise of rights to purchase Northwest stock or the receipt of such stock. In arriving at the deficiency the Commissioner determined that petitioners received dividend income in the amount of $2,800.64. It was alleged in the notice of deficiency that this amount was equal to the excess of the fair market value of the common stock of Northwest received by petitioners at the time of exercise of their rights over the amount paid by petitioners for said stock, whereas in fact the correct amount of such excess was $2,560. The determination by the Commissioner that petitioners received dividend income in the amount of the excess of the fair market value of the common stock of Northwest at the time of the exercise of their rights over the amount paid by petitioners for said stock was in accordance with a ruling issued by the Commissioner of Internal Revenue on June 28, 1961, affirmed on November 15, 1962, as follows:

"(1) The receipt by the shareholders of the Pacific Company of rights to purchase shares of stock of the Northwest Company will not result in taxable income to the shareholders.

[170] (2) No taxable income will result to the shareholders of the Pacific Company by reason of holding the above-described rights to purchase shares of stock of the Northwest Company until the date of expiration of the rights, without having exercised, sold or exchanged them.

(3) The full amount realized by the shareholders of the Pacific Company upon the sale or exchange of the above-described rights to purchase shares of stock of the Northwest Company will constitute ordinary income to the shareholder so selling or exchanging the rights.

(4) The receipt by the shareholders of the Pacific Company of stock of the Northwest Company upon the exercise of the above-described rights, in case of each shareholder which is not a corporation, will result in a distribution of property under section 301 of the Code in an amount equal to the excess, if any, of the fair market value of the stock of the Northwest Company at the time of the exercise of the rights over the amount paid for the stock; and, in the case of each shareholder which is a corporation will result in a distribution of property under section 301 in an amount equal to the excess, if any, of the basis of the stock of the Northwest Company in the hands of the Pacific Company at the time of the exercise of the rights over the amount paid for the stock, assuming the basis of such stock is less than its fair market value.

The amount of the distribution, as determined above, will constitute a dividend to the extent provided for [171] in sections 301(c) and 316 of the Code.

Neither section 346 nor section 355 of the Code will be applicable to the receipt by the shareholders of the Pacific Company of stock of the Northwest Company upon exercise of the above-described rights."

Wherefore, the petitioners pray that this Court may hear the proceeding, redetermine the deficiency involved herein by the correction of the errors alleged herein, and grant such other relief as may be proper.

EXHIBIT A

[173] Letterhead of

U. S. Treasury Department
Internal Revenue Service
District Director
P. O. Box 1706
New York 17, N. Y.
Jul 19 1963

In Reply Refer To
Form L-21
AU:R:90D

Mr. Irving Gordon and
Mrs. Margaret Gordon
Husband and Wife
411 West End Avenue
New York 24, New York

Taxable Year Ended	Deficiency
12-31-61	$895.10

Dear Sir and Madam:

In accordance with the provisions of existing internal revenue laws, notice is given that the determination of your income tax liability for the above-noted taxable year(s) discloses a deficiency (or deficiencies) in the amount(s) shown above. The attached statement shows the computation of the deficiency or deficiencies.

IF YOU AGREE to this determination, please sign the enclosed agreement, Form 870, and return it promptly

to this office. An addressed envelope is enclosed for this purpose. The signing and filing of this agreement will permit an early assessment of the deficiency or deficiencies and will limit the accumulation of interest.

IF YOU DO NOT AGREE, and do not sign and return the enclosed form, the deficiency or deficiencies will be assessed for collection, as required by law, upon the expiration of ninety days from the date of this letter, unless within that time you contest this determination in the Tax Court of the United States by filing a petition with that Court in accordance with its rules, a copy of which may be obtained by writing to its Clerk, Box 70, Washington 4, D. C.

Very truly yours,
Mortimer M. Caplin
Commissioner
By Charles A. Church
Charles A. Church
District Director

[174] Statement

Irving Gordon and Margaret Gordon
Husband and Wife
411 West End Avenue
New York 24, New York

Tax Liability for the Taxable Year Ended
December 31, 1961

Income Tax

Taxable Year Ended	Deficiency
December 31, 1961	$895.10

The deficiency is based on adjustments and explanations as set forth in detail below.

Adjustment to Income

Taxable income disclosed by return	$18,331.35
Unallowable deductions and additional income:	
(a) Dividend income	2,800.64
Taxable income adjusted	$21,131.99

Explanation of Adjustment

(a) The Pacific Telephone and Telegraph Company issued rights to shareholders of record at September 20, 1961 to acquire stock in the Pacific Northwest Bell Telephone Company. At that date you owned 1,540 shares of Pacific Telephone and Telegraph Company stock.

On October 5, 1961 you exercised the rights and acquired 256 shares of Pacific Northwest Bell Telephone Company stock for $4,096.00. The fair market value of such shares was $6,896.64. It is held that the difference between the fair market value and the cost of the stock is taxable as a dividend. Your income has therefore been increased in the amount of $2,800.64.

[175] Irving Gordon and Margaret Gordon Statement

Computation of Tax

Taxable income adjusted		$21,131.99
Tax on $21,131.99		$ 5,710.16
Less: Dividends received credit, adjusted		454.95
Tentative tax		$ 5,255.21
Add: Self-employment tax per return		216.00
Corrected income tax liability		$5,471.21
Income tax liability disclosed by return	$4,928.66	
Less: Dividends received credit per return	352.55	4,576.11
Deficiency in income tax		$ 895.10

Filed
1963 Nov. 4
Tax Court
of the
United States

[179] IRVING GORDON and MARGARET GORDON, Petitioners, v. COMMISSIONER OF INTERNAL REVENUE, Respondent.	Docket No. 3949-63

ANSWER

THE RESPONDENT, in answer to the petition filed in the above-entitled case, admits, denies and alleges as follows:

1, 2 and 3. Admits the allegations of paragraphs 1, 2 and 3 of the petition.

4(a) to (h), inclusive. Denies that the Commissioner erred as alleged in subparagraphs (a) to (h), inclusive, of paragraph 4 of the petition.

5(a) to (i), inclusive. Denies the allegations of subparagraphs (a) to (i), inclusive, of paragraph 5 of the petition.

5(j). Admits that during 1961, petitioners owned 1,540 shares of common stock of The Pacific Telephone & Telegraph Company (hereinafter referred to as Pacific), and that petitioners received under the Plan with respect to such shares, 1,540 rights to purchase common stock of

Pacific Northwest Bell Telephone Company (hereinafter [180] referred to as Northwest). Further admits the allegations of the second, third, fifth, sixth and seventh sentences of subparagraph (j) of paragraph 5 of the petition; denies that the rulings dated June 28, 1961, and November 15, 1962, were issued by the Commissioner of Internal Revenue, and that the quoted matter represents the full text of said rulings; alleges that said rulings were issued by the Director of the Tax Rulings Division; and denies the remaining allegations of said subparagraph.

6. Denies generally each and every allegation of the petition not hereinbefore specifically admitted, qualified or denied.

7. FURTHER ANSWERING the petition, and in support of the respondent's determination that the petitioners received dividend income in the year 1961, the respondent alleges:

(a) The stock rights received by the petitioners from Pacific in 1961 had an average fair market value of approximately $1.66 per right on October 5, 1961.

(b) Of the 1,540 rights received by the petitioners in 1961, four of such rights were not exercised by the petitioners.

(c) The full amount realized by the petitioners upon the sale or exchange in the year 1961 of any of those four rights not so exercised constitutes ordinary income to them on the date so realized.

[181] 8. IN FURTHER SUPPORT of the respondent's determination that the petitioners received dividend

income in the year 1961, and in the alternative in the event the Court sustains such determination but further determines that such dividend income was not realized upon the exercise, and upon the sale or exchange, of stock rights, the respondent alleges:

(a) In 1961, the petitioners received from Pacific 1,540 rights to purchase the common stock of Northwest. Those rights were issued by Pacific to petitioners on September 29, 1961.

(b) The average fair market value of such rights on September 29, 1961, was approximately $1.75 per right.

(c) The petitioners realized dividend income in the year 1961 upon the issuance of said rights or by reason of the issuance of such rights in the amount of the fair market value of such rights on the date of issue to petitioners.

WHEREFORE, it is prayed:

1. That the relief sought in the petition be denied;

2. That the deficiency in income tax for the taxable year 1961, as set forth in the statutory notice, be in all respects approved;

[182] 3. That the Court determine that the petitioners further received ordinary income in the year 1961 in the amount received in that year upon the sale or exchange of any unexercised stock rights. Claim for any increased deficiency in income tax for the petitioners' taxable year 1961 which may result from the Court's determination is hereby made pursuant to the provisions of section 6214(a) of the Internal Revenue Code of 1954; and

4. That, in the alternative, a deficiency in income tax for the taxable year 1961 be approved in the amount which results from the respondent's alternative contention as to the time of realization of dividend income.

[183] The Tax Court of the United States

IRVING GORDON and MARGARET GORDON, Petitioners, vs. COMMISSIONER OF INTERNAL REVENUE, Respondent.	FILED 1963 Dec. 19 Tax Court of the United States Docket No. 3949-63

REPLY

The above-named petitioners, for reply to the affirmative allegations of the answer filed by the respondent in the above-entitled case, admit, deny and allege as follows:

7(a) and (b). Admit the allegations of subparagraphs (a) and (b) of paragraph 7 of the answer.

7(c). Allege that on October 5, 1961 petitioners sold the four rights referred to in subparagraph 7(b) of paragraph 7 of the answer, and received therefrom net proceeds of $6.36; but deny that the full amount realized from such sale, or any amount so realized, constituted ordinary income to petitioners on the date [184] so realized or on any other date; and allege that the net proceeds so received on such date constituted proceeds from the sale of a capital asset, either nontaxable as a return of their basis in Pacific stock, or taxable as capital gain or loss to the extent that such proceeds exceeded or fell short of an allocable portion of such basis; or in the alternative, allege that the net proceeds received from sale of the rights constituted dividend income realized by

petitioners on such date, taxable under sections 301 and 316 of the Internal Revenue Code of 1954.

8(a) and (b). Admit the allegations of subparagraphs (a) and (b) of paragraph 8 of the answer.

8(c). Deny each and every allegation of subparagraph (c) of paragraph 8 of the answer.

9. Deny generally each and every allegation of the answer not hereinabove specifically admitted, qualified or denied.

Wherefore, the petitioners pray that the affirmative relief sought in prayers 3 and 4 of respondent's answer be denied, and that this Court may find as alleged herein and redetermine the deficiency in accordance with the petition and this reply.

[191] The Tax Court of the United States

Tax Court of the U.S.
Filed at
Washington, D.C.
Dec. 15, 1964

OSCAR E. BAAN and EVELYN K. BAAN, Petitioners, vs. COMMISSIONER OF INTERNAL REVENUE, Respondent.	Docket No. 949-63
IRVING GORDON and MARGARET GORDON, Petitioners, vs. COMMISSIONER OF INTERNAL REVENUE, Respondent.	Docket No. 3949-63

CONSOLIDATED STIPULATION OF FACTS

It is hereby stipulated that, for the purposes of this proceeding, the following statements shall be accepted as facts, and all exhibits referred to herein and attached hereto are incorporated in this stipulation and made a part hereof; provided, that any party hereto may introduce other and further evidence not inconsistent with the facts herein stipulated.

[192] No inference shall be drawn from this stipulation that the entries and conclusions reflected in the books and records or schedules prepared therefrom and other documents prepared by or in behalf of The Pacific Telephone and Telegraph Company and of Pacific Northwest Bell Telephone Company, which are stipulated herein, repre-

sent the proper treatment for Federal income tax purposes of all of the items or transactions recorded or contemplated therein. The stipulation of the term "dividends" or "cash dividends" in this stipulation is not intended to foreclose the respondent in his contention in this case that there were additional dividends distributed by The Pacific Telephone and Telegraph Company in 1961 and 1963. By using the terms "in conformance with the provisions of the Plan," "pursuant to the Plan", or like language used herein, the parties do not intend to stipulate that the action or transactions stipulated in connection with such terms are necessarily inseparable one from the other, for the purpose of the application of the so-called step transaction doctrine.

1. Petitioners OSCAR E. BAAN and EVELYN K. BAAN, Docket No. 949-63, were husband and wife, and residents of Sausalito, California, in their taxable year 1961. Said petitioners filed their joint Federal income tax return for the calendar year 1961 on a cash receipts and disbursements basis with the District Director of Internal Revenue at San Francisco, California. A copy of their return is attached as Exhibit 1-A.

[193] 2. Petitioners IRVING GORDON and MARGARET GORDON, Docket No. 3949-63, were husband and wife, and residents of New York City, New York, in their taxable year 1961. Said petitioners filed their joint Federal income tax return for the calendar year 1961 on a cash receipts and disbursements basis with the District Director of Internal Revenue for Manhattan District of New York at New York City, New York. A copy of their return is attached as Exhibit 2-B.

3. The Pacific Telephone and Telegraph Company (hereinafter "Pacific") is a California corporation which furnishes communication services, mainly local and long-distance (toll) telephone services, in the State of California. Prior to July 1, 1961, it furnished such services also in the states of Oregon, Washington and a northern portion of Idaho. Its wholly owned subsidiary corporation, Bell Telephone Company of Nevada, furnishes such services in Nevada.

4. Pacific Northwest Bell Telephone Company (hereinafter "Northwest"), a Washington corporation, has, commencing on July 1, 1961, furnished such services in the territory formerly served by Pacific in Oregon, Washington and Idaho.

5. Revenues from telephone services constitute approximately 90 per cent of the total operating revenues of the above three corporations. Other communications services furnished include teletypewriter services, and services and facilities for private-line teletypewriter use, for the transmission [194] of radio and television programs and for other purposes. Revenues are also received from the sale of advertising space in telephone directories.

6. In each state in which it operates, each of the above three corporations is subject to regulation by a state public utility regulatory authority which has power within its jurisdiction to regulate intrastate rates, services and other matters, including but not limited to some or all of the following: facilities, security issues, valuations, purchases and sales of property, budgets, the assessment of fees for the expenses of such authorities, and contracts

and other relations with affiliated corporations. All three corporations are likewise subject to regulation by the Federal Communications Commission with respect to their method of accounting and to interstate rates, lines and services, valuations and other matters. The Federal Communications Commission prescribes a Uniform System of Accounts which it requires telephone companies to use in keeping their books.

7. During all of the year 1961, the capital stock of Pacific consisted of the following:

(a) 820,000 shares of 6 per cent cumulative preferred stock authorized with a par value of $100 per share, entitled to 7 votes per share held, of [195] which stock 820,000 shares were issued and outstanding, with an aggregate par value of $82,000,000; and

(b) 105,000,000 shares of common stock authorized with a par value of $14-2/7 per share, entitled to one vote per share held, of which stock 104,756,943 shares were issued and outstanding, with an aggregate par value of $1,496,527,844.

8. The Articles of Incorporation of Pacific as they existed at all times during the year 1961 are attached as Exhibit 2-B(1). The duly adopted by-laws of Pacific as they existed during the year 1961 are attached as Exhibit 2-B(2). A copy of the form of preferred stock certificate employed by Pacific at all times during 1961 is attached as Exhibit 2-B(3).

9. Pacific's capital stock and surplus on its books of account as of December 31, 1960, and as of December 31, 1961, were as follows:

	December 31, 1960	December 31, 1961
Capital stock—preferred stock	$ 82,000,000.00	$ 82,000,000.00
Capital stock—common stock	1,496,527,844.28	1,496,527,844.28
Unappropriated earned surplus	192,053,880.76	178,935,190.15
Other capital surplus	-0-	101,326,128.38

Pacific's long-term funded debt at all times in 1961 was as follows:

[196] Funded Debt (Debentures)

Number of Years	Per Cent of Interest Rate	Date Due	Amount
Thirty	3¼	March 1, 1978	$ 75,000,000
Twenty-seven	3¼	November 15, 1979	35,000,000
Twenty-three	5⅛	August 1, 1980	90,000,000
Thirty	3½	November 15, 1981	30,000,000
Thirty-five	3⅛	September 15, 1983	75,000,000
Forty	2¾	December 1, 1985	75,000,000
Forty	2⅞	October 1, 1986	75,000,000
Forty	3⅛	October 1, 1987	100,000,000
Thirty-two	4⅜	August 15, 1988	78,000,000
Thirty-five	3⅛	November 15, 1989	50,000,000
Thirty-two	4⅝	November 1, 1990	80,000,000
Thirty-six	3⅝	August 15, 1991	67,000,000
Thirty-three	5⅛	February 1, 1993	72,000,000
Total Funded Debt			$902,000,000

10. Pacific has from time to time carried out its temporary financing by means of advances from its parent company, American Telephone and Telegraph Company (hereinafter "American"), a New York corporation. These loans are evidenced by demand notes due one day after date of issuance, which bear interest at 4½ per cent per annum. Normally, Pacific discharges such advances through the use of the proceeds from its issuance and sale of its common stock and long-term debentures. Attached as Exhibit 3-C is a schedule showing the date of issue and

amounts of those advances which make up the total as at January 1, 1961, and showing the month-end balances for each month of the year 1961.

[197] 11. American operates a network of cable, wire and radio circuits and related equipment for intercommunication between and through the territories of its telephone subsidiaries and of other telephone companies and for interconnection (including interconnection by underseas cables and by radio circuits) between telephone systems in the United States and those in many other countries or territories throughout the world.

American's telephone subsidiaries, including Pacific and Northwest, furnish local and toll service in the territories in which they operate and toll service between points within and points outside of such territories, toll service being furnished partly in conjunction with American and other telephone companies. American's subsidiaries operate in the District of Columbia and in every state except Alaska and Hawaii. American estimates that over 90 per cent of the toll messages originating in the United States are routed in whole or in part over its lines or those of its subsidiaries. A listing of the operating telephone company subsidiaries of American, their operating territory, and the per cent of their stock American owns is attached as Exhibit 3-C(1).

American owns 99.8 per cent of the stock of Western Electric Company, Incorporated (hereinafter "Western"). The principal business of Western is manufacturing telephone apparatus, cable, switchboards, etc., chiefly for American [198] and its telephone subsidiaries, procuring and selling to such companies materials and supplies not

of its own manufacture, and installing central office equipment for such companies.

American furnishes to its principal telephone subsidiaries and two associated non-controlled companies technical and other services. Certain of such services are performed directly by American and other services are performed by Bell Telephone Laboratories, Incorporated, (hereinafter "Bell Laboratories") which conducts scientific research and development and engineering work for American and for Western. At the present time a substantial portion of the work which Bell Laboratories performs for Western is in connection with Government contracts, principally related to defense activities.

12. American at all times during 1961 owned 90.25 per cent of the outstanding common stock and 78.17 per cent of the outstanding preferred stock of Pacific, representing in the aggregate 89.62 per cent of the total voting power of Pacific. American has owned more than 80 per cent of the total voting power of the stock of Pacific at all times since 1907.

13. The minority common and preferred shares of Pacific are publicly held. At the time of Pacific's annual shareholders' meeting in 1961 it had over 38,000 shareholders. For several years prior to 1961, during all of 1961, and at all times since 1961 the common shares and preferred shares [199] of Pacific have been listed for trading on the New York Stock Exchange and the Pacific Coast Stock Exchange.

14. Commencing with the year 1907, Pacific has employed the calendar year as its accounting year and has

kept its books of account to the extent permitted by law on the basis of the accrual method of accounting. Commencing with the year 1914, Pacific has filed its Federal income tax returns on the basis of the calendar year and to the extent permitted by law on the basis of the accrual method of accounting. Since January 1, 1913, Pacific has maintained its accounts in accordance with the Uniform System of Accounts for telephone companies prescribed originally by the Interstate Commerce Commission and since July 1934 by the Federal Communications Commission. For the taxable years 1924 through 1931, Pacific filed, as the parent corporation, consolidated Federal income tax returns with its own subsidiaries. For the taxable years 1932 through 1953, Pacific filed separate corporate Federal income tax returns. For the taxable years 1954 through 1962, Pacific was included as an affiliated subsidiary in the consolidated Federal income tax return of American. Commencing with the taxable year 1961, this consolidated Federal income tax return, with American as the parent corporation, included and was filed on behalf of Northwest as well as the other affiliated corporations. In none of the consolidated Federal income tax returns of American and its [200] affiliates for the taxable years 1954 through 1962 did the members of the affiliated group elect, as permitted under section 1.1502-31(b)(1) of the Income Tax Regulations, to take into account in the computation of consolidated taxable income the gains and losses reflected in certain intercompany transactions. The foregoing stipulation of the choice of American and its affiliates not to elect to take intercompany transactions into account is solely for the purpose of this stipulation.

15. During the 6 years ending December 31, 1961, the proportion of total communications revenues of Pacific and Northwest derived from intrastate communications services (which consist of communications services, local and long distance, originating and terminating in the same state) in each of the aforementioned states was as follows:

State	Percentage of total communications revenue derived from intrastate communications services
California	85.3%
Oregon	70.9%
Washington	76.6%
Idaho	71.7%
Over-all	83.1%

[201] The proportion of telephone plant in service of Pacific allocable to intrastate operations in each of the aforementioned states for the 5 years ending June 30, 1961, based on average plant balances for the month of June of each year, was as follows:

State	Percentage of telephone plant in service allocable to intrastate operations
California	86.7%
Oregon	71.6%
Washington	78.8%
Idaho	78.7%
Over-all	84.4%

16. For more than five years preceding June 30, 1961, certain activities of Pacific were carried on from places of business of Pacific located inside the same state (considering Washington and the small portion of Idaho

served as one state) in which Pacific's services were provided and its customers receiving such services were located, including but not limited to the following:

(1) Billing and collection of revenues for telephone and other services.

(2) Installation, maintenance and removal of telephones and other equipment owned by Pacific and placed on the customers' premises.

[202] (3) Installation and maintenance of telephone poles and lines.

(4) Maintenance of local banking accounts or arrangements for routine receipts and disbursements.

(5) Administration of personnel matters.

(6) Activities of sales representatives (other than directory advertising salesmen who work on a continuous circuit).

(7) Maintenance of area books of account and supporting accounting records.

17. For more than four years preceding January 22, 1960, the activities of Pacific carried on in each of the States of Oregon and Washington (considering the portion of Idaho served as a part of Washington) were under the direct management and control of a Vice-President and General Manager of the Oregon area and a Vice-President and General Manager of the Washington-Idaho area, the accounting functions of each area being under the control of an area auditor. On January 22, 1960, the activities of Pacific in the States of Oregon, Washington and Idaho were unified into a newly created division of Pacific known as "Pacific Telephone—Northwest, a Di-

vision of The Pacific Telephone and Telegraph Company." The new division had headquarters in Seattle, Washington, and maintained a second office for its President in Portland, Oregon. Commencing on January 22, 1960, the activities of Pacific in Oregon, Washington and Idaho were placed under the direct management and [203] control of the new division, with W. W. Straley as President of such division, a Vice-President and General Manager for each of the above-mentioned two areas, and an area auditor for each of the two areas. The activities previously carried on in the two areas for which the new division became responsible included but were not limited to the following:

(1) Engineering and construction of telephone plant, including contract approvals.

(2) Plant maintenance.

(3) Furnishing of telephone service.

(4) Billing of and receiving payment for telephone service.

(5) Wage contract negotiations.

(6) Payment of wages.

(7) Hiring, etc., of employees.

(8) Personnel administration.

(9) Purchase of equipment and supplies.

(10) Maintenance of area books of account and other records.

(11) Payment of property taxes and local taxes and licenses.

(12) Payment for goods and services.

(13) Preparation and filing of tariffs with state regulatory commissions.

(14) Execution of notes on borrowings from local banks.

[204] With respect to the larger construction projects, major leases and higher salary levels, the direct management and control by each Vice-President and General Manager prior to January 22, 1960, was subject to review at a higher corporate level. When Pacific's new division was created on January 22, 1960, this higher review was placed in the hands of the new president of the division, he in turn being directly responsible to the President of Pacific.

18. For more than five years preceding June 30, 1961, two advisory councils were maintained by Pacific, one for the Oregon area and one for the Washington-Idaho area, to advise the area Vice-President and General Manager, prior to January 22, 1960, and the division president, commencing on January 22, 1960, in matters pertaining to the company's operations in each area. The Washington-Idaho area council was established on October 14, 1954, and the Oregon area council was established on January 6, 1955. These councils were appointed by the board of directors of Pacific on nomination of its President and acted solely in an advisory capacity to management. The members of the councils were drawn, in part, from employees and directors of Pacific and, in part, from prominent men in the business communities of the aforementioned areas served by Pacific, in a similar manner to the board of directors of Pacific.

19. Without agreeing in any way that the transactions involved in this proceeding come within the provisions of sections 355 and/or 346 of the Internal Revenue Code of 1954 **[205]** (hereinafter "the Code"), the respondent agrees that: for more than five years prior to June 30, 1961, the operations of Pacific in the States of Oregon, Washington and a northern portion of Idaho constituted one or more telephone communications businesses operated by Pacific which were separable from the telephone communications business operated by Pacific in the State of California. Pacific has continued at all times after June 30, 1961, in the operation of the telephone communications business in California. In so stipulating the respondent is not agreeing that any of the other requirements of sections 355(b) and 346(b) of the Code have been met for purposes of this proceeding. The respondent specifically does not agree that the requirements of sections 355(b)(2)(C) and 355(b)(2)(D) and the similar requirements of section 346 have been so met.

20. Attached as Exhibits 4-D and 5-E, respectively, are copies of summary balance sheets and summary income statements, respectively, both taken from and representative of the books and records of Pacific for the years ended December 31, 1950 through 1963.

21. Between the end of World War II and January 1, 1961, there was a substantial increase in the demand for telephone service in the area served by Pacific. The number of telephones increased almost threefold from 2,700,000 to about 8,000,000. The investment in telephone plant (without deducting the depreciation reserve) increased more than **[206]** fivefold from $662,000,000 to

$3,402,000,000; and annual operating revenues increased more than fourfold from $243,000,000 to $1,120,000,000. The operations of Pacific in the single State of California in 1960, in terms of plant investment and operating revenues, exceeded those of the entire company in California, Oregon, Washington and Idaho in 1957. The operations of Pacific in Oregon, Washington and Idaho in 1960 almost equalled those for the entire company at the end of World War II. Growth in all the Pacific Coast states was continuing in 1961 at a rapid pace. Recent studies had predicted the population of California would increase from about 16,100,000 at the end of 1960 to more than 20,000,000 in 1970. Large population increases were also expected in the other states in which Pacific did business.

22. In terms of total capital, Pacific at the end of 1960 was the largest subsidiary corporation in the Bell System and the eighth largest non-financial company in the nation. On the same basis Northwest, as of July 1, 1961, was larger than eight and smaller than twelve of the other Bell System subsidiaries. It was the largest public service company in the Pacific Northwest area. Attached as Exhibits 6-F and 6-F(1) are schedules ranking in terms of total capital the top 10 non-financial companies in the United States in 1960 and the top 4 public service companies in the [207] Pacific Northwest in 1961. Attached as Exhibit 7-G is a schedule showing the total capital, the value of net telephone plant, and the number of telephones for each of the 21 Bell System telephone company subsidiaries in 1961.

23. Attached as Exhibit 8-H are six graphs showing the following statistics of Pacific for the State of Cali-

fornia, the first four of which cover the years 1930 through 1961, and the last two of which cover the years 1937 through 1961:

Telephone plant in service at end of year;

Company stations at end of year;

Total telephone plant per company station at end of year;

Annual revenue per average company station;

Employees at end of year;

Total wage payments.

24. Attached hereto as Exhibits 9-I and 10-J, respectively, are schedules taken from the books and records of Pacific and entitled "Source and Application of Funds of Pacific for the Calendar Years 1958 through 1963," and "Source and Application of Funds of Pacific for the Twelve-month Periods Ended June 30, 1954 Through June 30, 1963." As Exhibit 10-J indicates, Pacific issued additional common stock and/or long-term debentures in each of the seven 12-month periods ending with June 30, 1960. The proceeds from the sale of these securities, net of expenses and premiums, were $1,313,750,000, or an [208] average for each of the seven years 1954-1960 of $187,678,600. In the 36-month period from July 1, 1960, through June 30, 1963, Pacific did not issue any additional common stock or debentures. During the entire ten-year period ended June 30, 1963, covered by Exhibit 10-J, Pacific expended the sum of $3,380,407,000 for additions to telephone plant, or an average for each of the ten years 1954-1963 of $338,040,700.

25. Attached hereto as Exhibit 11-K is a schedule containing information on the issued and outstanding common and preferred stock of Pacific.

26. Construction expenditures for the operations of Pacific in Washington, Oregon and part of Idaho (hereinafter "Pacific's Northwest area") from 1956 through June 30, 1961, and for Northwest from July 1, 1961, through December 31, 1962, were approximately as follows:

Year		Amount (in millions)
1956		$75
1957		83
1958		64
1959		58
1960		58
1961		
(first 6 mos.	$33	
(last 6 mos.	37	70
1962		79

Total plant investment after depreciation allowances for Pacific's Northwest area and for Northwest increased from approximately $451,000,000 at December 31, 1955, to $705,000,000 at June 30, 1961, and to $775,000,000 at December 31, 1962.

[209] 27. Attached hereto as Exhibits 12-L and 13-M, respectively, are a Statement of Earned Surplus for Pacific as taken from its books and records for the years 1950 through 1963 and a Statement of Earned Surplus for Northwest as taken from its books and records for the period July 1, 1961, to December 31, 1961, and for the years 1962 and 1963.

28. In a meeting on January 27, 1961, the board of directors of Pacific resolved to submit to the shareholders of Pacific a plan entitled "Plan For Reorganization of The Pacific Telephone and Telegraph Company" (hereinafter "Plan") for consideration at the annual meeting of the shareholders on March 24, 1961. An excerpt from the minutes of such meeting and the resolutions of the board is attached hereto as Exhibit 14-N. Mr. J. O. Einerman, Vice-President and Comptroller of Pacific, addressed the board on January 27, 1961, prior to its vote on the resolutions, and at the request of the Chairman of the board as referred to on the first page of Exhibit 14-N. A document entitled "Presentation of Plan" setting forth substantially what Mr. Einerman stated to the board, to which are appended copies of charts displayed by Mr. Einerman to the board, is attached as Exhibit 15-O. A copy of the Plan which was approved by the directors on January 27, 1961, is attached as Exhibit 16-P. A copy of the proxy statement dated February 27, 1961, mailed to each shareholder of record on February 14, 1961, together with a copy of the President's letter to the shareholders which accompanied the statement, is attached as Exhibit 17-Q.

[210] 29. On March 24, 1961, the shareholders of Pacific duly approved and adopted the Plan, as set forth in the proxy statement portion of Exhibit 17-Q, subject to consent and approval by the Federal Communications Commission and the public utility regulatory authorities in each of the States of Oregon, Washington and Idaho. An excerpt from the minutes of the shareholders' meeting of March 24, 1961, which includes the resolution

adopted by the shareholders is attached as Exhibit 18-R. The resolution was adopted by a vote of 107,388,657 votes for the Plan (97.19 per cent); 130,976 votes against (.12 per cent); and 2,977,335 votes not voting (2.69 per cent). The statement to the stockholders attending the annual meeting by the President of Pacific outlining the Plan is attached as Exhibit 19-S. A document entitled "Presentation of the Plan for Reorganization," setting forth substantially what Mr. J. O. Einerman, Vice-President and Comptroller of Pacific, who addressed the shareholders at the request of its President as referred to in Exhibit 19-S, stated to the shareholders is attached as Exhibit 20-T. Appended to Exhibit 20-T are copies of charts which Mr. Einerman displayed to the shareholders.

30. Pursuant to the Plan, Northwest was organized under the laws of the State of Washington on March 27, 1961, with an authorized capital stock consisting of 50,000,000 shares of one class common stock with a par value per share of $11. On March 28, 1961, 10,000 shares of such stock were issued by Northwest to Pacific upon the payment by Pacific [211] of $110,000 in cash. A copy of the form of common stock certificate of Northwest is attached hereto as Exhibit 21-U.

31. Pursuant to the Plan, on March 31, 1961, Pacific and Northwest submitted to the Public Utilities Commissioner of Oregon a joint application for an order authorizing Pacific to sell and Northwest to purchase the business and properties of Pacific in the State of Oregon and for certain related orders. On the same date, Pacific and Northwest submitted to the Washington Public Service Commission a joint application for an order authorizing

Pacific to sell and Northwest to purchase the business and properties of Pacific in the State of Washington and authorizing the issuance of common stock and debt obligations of Northwest and the acquisition thereof by Pacific. On the same date, Pacific and Northwest submitted to the Idaho Public Utilities Commission a joint application of Pacific to withdraw its tariffs from Idaho and of Northwest to file tariffs with the Commission for Idaho. On April 3, 1961, Pacific and Northwest filed with the Federal Communications Commission a joint application for a certificate to the effect that the present and future public convenience and necessity required the acquisition and operation by Northwest of the interstate toll lines of Pacific located in the States of Oregon, Washington and Idaho, and for a certificate to the effect that neither the present nor future public convenience and necessity would be adversely affected by the discontinuance of interstate **[212]** telephone and telegraph services by Pacific over the lines to be acquired by Northwest.

32. On May 15, 1961, the Idaho Public Utilities Commission issued its approval order, a copy of which is attached as Exhibit 22-V; on June 5, 1961, the Washington Public Service Commission issued its order granting its approval, a copy of which is attached as Exhibit 23-W; on June 12, 1961, the Public Utilities Commissioner of Oregon issued his order granting his approval, a copy of which is attached as Exhibit 24-X; and, on June 15, 1961, the Federal Communications Commission issued its approval order and certificate, a copy of which is attached as Exhibit 25-Y, together with the application of Pacific to that agency. These exhibits are being stipulated for

the limited purpose of showing the basis for and scope of the action taken on the Plan by these regulatory bodies.

33. Attached as Exhibit 26-Z are excerpts from the minutes of a meeting of the board of directors of Pacific held on June 30, 1961, together with a copy of the agreement of transfer and the letter of subscription referred to on pages 1 and 2, respectively, of said excerpts. At this meeting the transfer of assets by Pacific and Northwest as contemplated by the Plan was approved. Pursuant to the Plan, as of 11:59 p.m. on June 30, 1961, all of the business and properties of Pacific in the States of Oregon, Washington and Idaho were transferred to Northwest in [213] consideration for:

(a) The assumption by Northwest of outstanding liabilities relating to the operations of Pacific in such states, with the exception of liabilities with respect to dividends declared on stock, income taxes for which liability reserves had been established and principal of and interest on debentures and short-term debt of Pacific;

(b) the issuance to Pacific by Northwest of a promissory note payable on demand in the principal amount of $200,000,000 bearing interest at the rate of 4½ per cent per annum (a copy of the promissory note is attached as Exhibit 27-AA); and,

(c) the issuance to Pacific by Northwest of an additional 30,450,000 shares of its $11 par value common stock, having an aggregate par value of $334,950,000.

34. As contemplated by the Plan, as of the close of business on June 30, 1961, Pacific ceased operation of the

business in the States of Oregon, Washington and Idaho, and as of July 1, 1961, Northwest commenced operation of the business received from Pacific in the States of Oregon, Washington and Idaho. A copy of the opening balance sheet of Northwest, taken from its books and records, is attached hereto as Exhibit 28-BB. This balance sheet reflected (in nearest thousands of dollars), in addition to the original capital of Northwest of $110,000, the cost per Pacific's books of assets transferred, less [214] the amount of liabilities assumed, of $576,936,000. Adjustments made by Northwest for organization expenses reduced its opening book value of net assets to $576,629,000. The par value of stock, aggregate debt (including advances from American evidenced by promissory notes due one day after issue), surplus per books and net book cost of assets less liabilities (a) of Pacific immediately prior to the above-mentioned transfer and (b) of Northwest as of commencement of business on July 1, 1961, were as follows:

	(a) Pacific		(b) Northwest	
	Amount	Per cent	Amount	Per cent
Stock	$1,578,527,844	54.0	$335,060,000	58.0
Debt:				
Funded	902,000,000			
Advances from American	233,000,000			
Demand note			200,000,000	
Total debt		38.9		34.7
Surplus	207,043,321*	7.1	41,986,477**	7.3
Total Capitalization***	$2,920,571,165	100.0	$577,046,477	100.0

*Before reduction by retroactive depreciation adjustment.

**Before reduction by retroactive depreciation adjustment described in note (d) of Exhibit 28-BB, and by capital stock expense.

***Equal to net book cost of assets less liabilities.

35. The total capitalization of Northwest was arranged in such a way as to maintain substantially the same ratios of stock, aggregate debt and surplus as those of [215] Pacific as set forth above. The approximate aggregate par value of capital stock of Northwest to be outstanding having been thus determined, the $11 par value per common share and the approximate number of common shares of Northwest to be outstanding were determined by March 27, 1961, the date of incorporation of Northwest. The $11 par was selected, after review of the normal relationship between par value and market price of the common shares of Pacific's stock, with a view to a price range for the common shares of Northwest's stock which would be most attractive to investors. It was believed that the relationship between the price range at which the Northwest stock would be traded on the exchange and the book value of the Northwest stock would be approximately equal to the relationship between the price range at which the Pacific common stock would be traded and the book value of the Pacific common stock, such future price range of Pacific common stock being forecast in the light of the current prices of Pacific common stock.

36. Attached hereto as Exhibit 29-CC are copies of the following letters and memoranda:

(1) a letter dated June 19, 1961, signed by Ben F. Waple, Acting Secretary of the Federal Communications Commission, received by Mr. J. O. Einerman, Vice President and Comptroller of Pacific.

(2) a letter dated June 23, 1961, signed by Mr. Einerman and received by Mr. Waple.

[216] (3) a memorandum dated July 6, 1961, signed by Noah D. Clinard of the Telephone Compliance Staff of the Federal Communications Commission, entitled "Notes on Conference held in Washington, D.C., on June 22, 1961, with a Representative of the American Telephone and Telegraph Company." It is hereby stipulated that the memorandum sets forth the substance of what was stated by the persons named in the memorandum, at the conference in Washington, D.C., of June 22, 1961, which is described therein.

(4) the relevant portion of a memorandum dated October 19, 1961, signed by Mr. Clinard, entitled "Notes on Conference held in Washington, D.C., on July 18, 1961, with Representatives of the American Telephone and Telegraph Company and a Representative of Lybrand Ross Brothers and Montgomery," and an undated, unsigned memorandum prepared on or before July 20, 1961, by one of the representatives of American named in the memorandum as present at the meeting described therein, being the same meeting in Washington, D.C., on July 18, 1961, described in the portion of Mr. Clinard's memorandum. It is hereby stipulated that the two memoranda of the meeting in Washington, D.C., on July 18, 1961, when taken together, set forth the substance of what was stated by the persons named in the two memoranda, concerning the Plan of Pacific, at the conference described therein.

[217] (5) a letter dated August 23, 1961, signed by Mr. Einerman, and received by Mr. Waple.

(6) a letter dated November 17, 1961, signed by Mr. Einerman and received by Mr. Waple.

(7) a letter dated December 26, 1961, signed by Mr. Waple and received by Mr. Einerman.

It is hereby stipulated that the various persons whose surnames appear in Mr. Clinard's two memoranda are the same persons as the persons whose full names appear in the American memorandum of the July 18, 1961, conference, and that such persons at the time of the two meetings in 1961 held the positions ascribed to them in such American memorandum.

37. From March 28, 1961, until September 29, 1961, Pacific was the sole shareholder of Northwest. Pursuant to the Plan, on September 29, 1961, Pacific issued to its shareholders rights, evidenced by assignable warrants, to purchase 17,459,490 shares of the common stock of Northwest, constituting approximately 57.3 per cent of the total outstanding common shares of Northwest. A copy of the prospectus relating to this offering, mailed to each shareholder of Pacific of record as of the close of business September 20, 1961, is attached hereto as Exhibit 30-DD. A copy of the form of warrant issued is attached hereto as Exhibit 31-EE. A copy of the covering letter to which such warrants were attached is attached hereto as Exhibit 32-FF.

[218] 38. In conformance with the provisions of paragraph 4(a) of the Plan, identified as Exhibit 16-P herein, each minority common shareholder of Pacific of record at the close of business on September 20, 1961, was issued one right for each common share of Pacific so held. The number of common shares of Pacific so held by minority shareholders was 10,214,804. At the close of business on

September 20, 1961, American held 94,542,139 shares of common stock and 640,957 shares of preferred stock of Pacific. Under the Plan, 1,253,301 rights were received by the minority preferred shareholders of Pacific on the basis of seven rights for each preferred share of Pacific held by them. These 1,253,301 rights came from rights which American would otherwise have received with respect to its common shares of Pacific, on the basis of one right for each common share of Pacific which American held. Consequently, American received on September 29, 1961, 93,288,838 rights with respect to its 94,542,139 common shares of Pacific. American received no rights with respect to its preferred shares of Pacific.

Under the terms of the offering, six rights and the payment of $16 were required for the purchase of each share of common stock of Northwest. The rights were required to be exercised no later than October 20, 1961.

39. As a result of the offering described in paragraphs 37 and 38, the minority common and preferred [219] shareholders of Pacific or their assignees acquired by exercising rights 1,897,891 shares of common stock of Northwest, and American (after purchasing two additional rights privately) on September 29, 1961, acquired all of the 15,548,140 shares of such stock for which it had received rights. The 17,446,031 shares of Northwest thus acquired by the shareholders of Pacific or their assignees by exercising rights had an aggregate fair market value of $468,852,920 at the various dates of exercise of the rights, as shown by the average of the high and low quotations on the American Stock Exchange (the principal market in which such stock was traded). Pacific received

by reason of such acquisitions, cash in the amount of $279,136,496, of which amount $248,770,240 was received from American by its check dated September 29, 1961.

40. The common stock of Northwest was listed on the American Stock Exchange and on the Pacific Coast Stock Exchange, and trading with respect to the shares of such stock commenced on September 14, 1961, on a when-issued basis. The rights issued by Pacific on September 29, 1961, were admitted to trading on the American Stock Exchange and on the Pacific Coast Stock Exchange and trading with respect to said rights commenced on September 14, 1961, on a when-issued basis.

41. The offering price of $16 per share to Pacific shareholders of the portion of the common stock of Northwest offered to them in 1961 was determined by Pacific at a meeting of its board of directors on August 25, 1961. A copy of the minutes of such meeting and of the resolutions of the board [220] is attached hereto as Exhibit 33-GG. A document entitled "Presentation to Directors—August 25" containing substantially what Mr. J. O. Einerman, Vice-President and Comptroller of Pacific, stated to the board at the request of its President, as referred to on the first page of Exhibit 33-GG is attached as Exhibit 34-HH. To this exhibit are appended copies of charts which Mr. Einerman displayed to the board on that occasion.

42. Attached hereto as Exhibit 35-II is a schedule showing the issuance of rights by Pacific to its stockholders to purchase its common stock and covering the years 1953 through 1963. All such rights were assignable similar to the terms of Exhibit 31-EE and represent, ex-

cept for the rights referred to in paragraphs 37 above, and 45 below, all rights to purchase stock issued by Pacific during those years,

43. As a result of the transfer of assets and assumption of liabilities referred to in paragraphs 33 and 34 above and of the exercise of rights in 1961 with respect to approximately 57 per cent of the outstanding stock of Northwest then held by Pacific as referred to in paragraphs 37, 38 and 39 above, accounting entries were made on the books of Pacific and Northwest affecting their surplus accounts as follows:

(1) The excess of

(a) $576,052,715.57, the book value of net assets received by Northwest from Pacific [221] ($576,936,477.26 at June 30, 1961, reduced by $883,761.69 to give effect to the retroactive depreciation adjustment described in note (d) of Exhibit 28-BB), over

(b) $534,950,000, equal to the par value of Northwest stock ($334,950,000) plus the face amount of the demand note ($200,000,000) issued by Northwest to Pacific in exchange for such assets, was, before adjustment for organization expenses borne by Northwest, recorded on the books of Northwest as retained earnings ($41,102,715.57).

(2) An amount similarly arrived at ($41,102,715.57) was recorded on the books of Pacific as a transfer from retained earnings to capital surplus, and the common stock and note of Northwest were recorded as assets having a value equal to the adjusted net

book value of Pacific assets transferred to Northwest ($576,052,715.57).

(3) Subsequently, upon the exercise of rights with respect to about 57 per cent of the common stock of Northwest held by Pacific, Pacific recorded on its books the excess of the proceeds of such stock ($279,136,496.00) over the sum of the carrying value of the stock ($215,455,741.76) and expenses and taxes attributable to the disposition ($2,493,079.05), as a credit to the capital surplus of Pacific ($61,187,675.19).

[222] Attached hereto as Exhibit 36-JJ is a copy of the entries by Pacific in its Account No. 179, Other Capital Surplus, for the Calendar year 1961.

44. Attached as exhibits are copies taken from the 1961 consolidated Federal income tax return of American of the following:

(a) Statement No. 8, sheet 21, entitled "Sale or Exchange of Property Under Section 1231" for Pacific, as Exhibit 37-KK;

(b) Statement No. 10, sheet 20, entitled "Long-Term Capital Gains and Losses—Assets Held for More Than Six Months" showing the net gain after selling expenses on sale of the Northwest stock for Pacific, as Exhibit 38-LL;

(c) Statement No. 25, sheets 54, 55 and 56 entitled "Reconciliation of Taxable Income and Analysis of Earned Surplus and Undivided Profit" for Pacific, as Exhibit 39-MM;

(d) Statement No. 25, sheets 59 and 60 entitled "Reconciliation of Taxable Income and Analysis of

Earned Surplus and Undivided Profits" for Northwest, as Exhibit 40-NN; and

(e) Statement No. 28, sheets 1 through 10 entitled "Information required to be filed by Section 1.351-3 of the Income Tax Regulations," as Exhibit 41-OO.

[223] The purpose of these five exhibits is to show how the various calendar year 1961 transactions relevant and material to this case were reported on such consolidated Federal income tax return for 1961.

45. On April 22, 1963, pursuant to the Plan, Pacific's board of directors resolved to offer the remaining 13,013,-969 shares of common stock of Northwest held by it to the shareholders of Pacific of record on June 4, 1963. A copy of the minutes of that meeting of the board of directors of Pacific and of the resolutions of the board is attached hereto as Exhibit 42-PP. A document entitled "Presentation to Directors—April 22, 1963" containing substantially what Mr. J. O. Einerman, Vice-President and Comptroller of Pacific, at the request of its President, as referred to on the first page of Exhibit 42-PP, stated to the board, is attached as Exhibit 43-QQ. Appended to the exhibit are copies of charts displayed by Mr. Einerman to the board on that occasion. On June 12, 1963, Pacific issued to its shareholders rights evidenced by assignable warrants to purchase all such shares at a price of $16 per share, exercisable at any time before the close of business on July 3, 1963. Rights were received by the minority common shareholders, minority preferred shareholders, and American, the common parent corporation of Pacific on the same basis as the 1961 offering of

Northwest shares as referred to in paragraph 38 above, except that American relinquished [224] rights to purchase 8,829 shares of Northwest which it would otherwise have received under the Plan with respect to its common shares of Pacific, so that the minority common and minority preferred shareholders of Pacific could be offered shares of Northwest on a one-for-eight basis. The exercise of eight rights was required for the purchase of each share of Northwest.

46. As a result of the 1963 offering, the minority common and preferred shareholders of Pacific or their assignees acquired by exercise of their rights 1,416,552 shares of Northwest, and American acquired the balance at $16 per share, including 11,580,456 shares for which it had received rights which it exercised, and 16,961 shares also acquired by American, as provided in the Plan, constituting the shares offered to the minority common and preferred shareholders of Pacific for which shares the rights were allowed to lapse by such shareholders, or a total for American of 11,597,417 shares. In the two offerings, in 1961 and 1963, American thus acquired a total of 27,145,557 shares of Northwest, or about 89.1 per cent of its single class of common stock.

47. The offering price of $16 per share to Pacific shareholders of the portion of the common stock of Northwest held by Pacific in 1963 and offered to the shareholders through rights in 1963 was determined by Pacific at a meeting of its board of directors on May 24, 1963. An excerpt from the minutes [225] of such meeting relative to such determination and of the resolutions of the board relative thereto is attached hereto as Exhibit 44-RR.

A document entitled "Presentation to Directors—May 24, 1963" setting forth substantially what Mr. J. O. Einerman, Vice-President and Comptroller of Pacific, at the request of its President, as referred to on Exhibit 44-RR, stated to the board is attached as Exhibit 45-SS. To this exhibit are appended copies of charts which Mr. Einerman displayed to the board on that occasion. Attached as Exhibit 46-TT is a copy of the Prospectus dated May 27, 1963, concerning such offering.

48. Attached as Exhibit 47-UU is a schedule showing the high, low and average daily prices on the New York Stock Exchange of Pacific's common and preferred stocks for selected dates during the year 1961.

49. Attached as Exhibits 48-VV and 49-WW, respectively, are schedules showing the high, low and average daily prices on the American Stock Exchange of Northwest's common stock from September 14, 1961, through October 20, 1961, and the high, low and average daily prices on that exchange of the rights issued by Pacific in 1961 to purchase the stock of Northwest for the same period of time.

50. Attached as Exhibit 50-XX is a schedule showing the high, low and average daily prices on the New York Stock Exchange of Pacific's common and preferred stocks for selected dates during the year 1963.

[226] 51. Attached as Exhibit 51-YY is a schedule showing the high, low and average daily prices on the American Stock Exchange of Northwest's common stock for selected dates during the year 1963.

52. Attached as Exhibit 52-ZZ is a schedule showing the high, low and average daily prices on the American Stock Exchange of the rights issued by Pacific in 1963 to purchase the stock of Northwest from May 28, 1963, through July 3, 1963. The prices reflected in Exhibits 47-UU through 52-ZZ are representative of the market price in this country for the specified stocks, rights and dates.

53. Attached as Exhibit 53-AAA is a schedule containing data regarding the minority shares and minority shareholders of Pacific on the record dates of September 20, 1961, and June 4, 1963 for the offering by Pacific, through rights, of the common stock of Northwest, and regarding such rights.

54. Attached as Exhibit 54-BBB is a schedule containing data regarding the response by the minority shareholders of Pacific to its offering through rights of the stock of Northwest in 1961 and 1963.

55. Attached as Exhibit 55-CCC is a schedule showing the net operating revenues of Pacific for its over-all operations and as broken down between its operations in Washington-Idaho, Oregon and California, all for the years 1950 through 1963, and showing such revenues for Northwest's over-all operations for the years 1961 through 1963.

[227] 56. Attached as Exhibit 56-DDD is a schedule taken from their books and records showing, for Pacific and for Northwest, and covering the calendar years 1950 through 1963 and a portion of 1964, selected statistics of operations and assets, divided into Pacific's California

area, Pacific's Northwest area, Pacific's total area, and since July 1, 1961, Northwest's total area. Attached as Exhibit 56-DDD(1) are condensed balance sheets of Pacific, taken from its books and records, as of three dates:

June 30, 1961
July 1, 1961
December 31, 1961

57. On June 30, 1961, Pacific had 15,761 employees located in the states of Oregon, Washington and Idaho. As of that date, all of these employees terminated their employment with Pacific, and, with rare exceptions, on the next day commenced employment with Northwest at the same position and the same location. The original officers of Northwest were all persons who had served as officers of the Pacific Telephone—Northwest Division of Pacific. The original directors of Northwest, with the sole exception of Mr. Dewayne Kreager, were persons who had served either on the advisory councils of Pacific for the Oregon area or the Washington-Idaho area, or as officers of Pacific or of the Pacific Telephone—Northwest Division. Attached as Exhibit 57-EEE is a schedule showing the original officers and directors of Northwest and their prior connection with the Bell System.

[228] 58. Attached as Exhibits 58-FFF and 59-GGG, respectively, are copies of summary balance sheets and summary income statements, both including other data and both taken from and representative of the books and records of Northwest for the years ended December 31, 1961 through 1963.

59. Northwest has continued at all times after June 30, 1961, in the operation of the telephone communications business formerly operated by Pacific in the states of Oregon, Washington and Idaho. Since June 30, 1961, Northwest has issued to the public debentures, the proceeds of which have been employed to refund (pay to Pacific) the $200,000,000 demand note given to Pacific by Northwest, as follows:

Date of Issue	Face Amount	Rate of Interest	Term (Years)
November 1, 1961	$50,000,000	4½%	33
September 1, 1962	50,000,000	4⅜%	40
April 1, 1963	50,000,000	4½%	40
December 1, 1963	50,000,000	4½%	37

The balance due Pacific by Northwest on the $200,000,000 demand note was finally extinguished on December 12, 1963.

60. Attached as Exhibit 60-HHH is a copy of a prospectus dated November 8, 1963, concerning an offering by Northwest of shares of its common stock pro rata to its shareholders.

Attached as Exhibit 60-HHH(1) is a copy of a prospectus dated April 21, 1964, concerning an offer by Pacific of $100,000,000 face amount of 35-year 4⅝ per cent [229] debentures. This offering of debentures was the first public offering of its own debentures or stock by Pacific since its offerings of debentures and stock in the year 1960.

61. Attached as Exhibit 61-III is a schedule taken from Pacific's books and records and showing its earnings per common share, its cash dividends paid per com-

mon and preferred share and its cash dividends paid as a percentage of earnings, all for the years 1947 through 1963. This schedule does not include any amounts in 1961 and 1963 which respondent contends in this case are dividends arising out of the rights offerings by Pacific as referred to in paragraphs 38 and 45 above, respectively.

62. Attached as Exhibit 62-JJJ is a schedule showing the net operating income, dividend income from Northwest, if any, other income and expenses, and net income of Pacific for the calendar years 1959 through 1963.

63. The Bell System constituted by American and its affiliated companies experienced considerable growth from the end of World War II through calendar year 1963. Attached as Exhibit 63-KKK is a schedule showing certain statistics on the Bell System which reflect, in part, such growth.

64. The aggregate adjusted Federal tax basis to Pacific of the properties transferred by it to Northwest as of 11:59 P.M. on June 30, 1961, was an amount in excess of the amount of aggregate liabilities of Pacific (on a [230] Federal tax basis) assumed by Northwest as of that same time.

65. At all times during 1961, petitioners OSCAR E. BAAN and EVELYN K. BAAN, Docket No. 949-63, owned 600 shares of common stock of Pacific, which had been purchased by them at various times prior to 1961, and which were held by them throughout 1961 as capital assets within the meaning of section 1221 of the Code. Attached as Exhibit 64-LLL is a schedule showing the dates, method of acquisition and cost of acquisition of

said 600 shares. As of September 29, 1961, Pacific issued to said petitioners warrants evidencing 600 rights to acquire common stock of Northwest. On October 11, 1961, said petitioners duly exercised all of such 600 rights, which entitled them to acquire 100 shares of common stock of Northwest, and paid to Pacific $1,600 in cash or $16 for each such share. By reason of the exercise of such rights, said petitioners received 100 shares of common stock of Northwest from Pacific. On October 11, 1961, the fair market value of said 100 shares, as shown by the average of the high and low quotations on the American Stock Exchange (the principal market in which such stock was traded), was $2,694.

66. In their joint Federal income tax return for 1961, petitioners OSCAR E. BAAN and EVELYN K. BAAN, Docket No. 949-63, did not include as income any amount with respect to the rights to purchase Northwest stock. It is agreed that the fair market value of $2,694 for the 100 shares of Northwest [231] stock purchased by said petitioners, as found by the statutory notice of deficiency received by said petitioners, was the fair market value of such shares on October 11, 1961, the date when said petitioners exercised their rights.

67. At all times during 1961, petitioners IRVING GORDON and MARGARET GORDON, Docket No. 3949-63, owned 1,540 shares of common stock of Pacific, which had been purchased by them at various times prior to 1961, and which were held by them throughout 1961 as capital assets within the meaning of section 1221 of the Code. Attached as Exhibit 65-MMM is a schedule showing the dates, method of acquisition and cost of acquisi-

tion of said 1,540 shares. As of September 29, 1961, Pacific issued to said petitioners warrants evidencing 1,540 rights to acquire common stock of Northwest. On October 5, 1961, said petitioners duly exercised 1,536 of such rights (all except 4) which entitled them to acquire 256 shares of common stock of Northwest, and paid to Pacific $4,096 in cash or $16 for each such share. By reason of the exercise of such rights, said petitioners received 256 shares of common stock of Northwest from Pacific. On October 5, 1961, the fair market value of said 256 shares as shown by the average of high and low quotations on the American Stock Exchange (the principal market in which such stock was traded) was $6,656.

68. On October 5, 1961, petitioners IRVING GORDON and MARGARET GORDON, Docket No. 3949-63, sold the 4 rights to [232] purchase Northwest stock which they had received from Pacific but did not exercise. Said petitioners received $6.36 net proceeds from such sale of rights.

69. In their joint Federal income tax return for 1961, petitioners IRVING GORDON and MARGARET GORDON, Docket No. 3949-63, did not include as income any amount with respect to the sale of rights to purchase Northwest stock or with respect to the exercise of rights to purchase Northwest stock or with respect to the receipt of such stock. It is agreed that the fair market value of $6,896.64 for the 256 shares of Northwest stock purchased by said petitioners, as found by the statutory notice of deficiency received by said petitioners, was not the fair market value of such shares on October 5, 1961, the date when petitioners exercised their rights, but rather $6,656

was the fair market value of such 256 shares on such date of exercise.

70. There was no surrender to Pacific of certificates of common stock or preferred stock of Pacific by its shareholders during the calendar years 1961 through 1963 or at any other time as a result of or in connection with the transfer of assets by Pacific to Northwest in 1961 as referred to in paragaph 28, above, and/or as a result of or in connection with the rights offerings by Pacific in 1961 and 1963 as referred to in paragraphs 37 and 45, above. The term "certificate" as used in this paragraph means the instrument evidencing record ownership [233] of the shares covered by such certificate.

71. There was a sufficient dollar amount of earnings and profits of Pacific in 1961 from which a 1961 dividend could have been paid by Pacific to its stockholders, to cover the dollar amounts which respondent contends were received by the petitioners in these cases and by the other shareholders of Pacific in 1961 with respect to Northwest rights.

72. Attached as Exhibit 66-NNN is a schedule taken from the books and records of Pacific showing the book value (net asset value) of the common stock of Pacific at the end of each of the months January through December, 1961.

73. Attached as Exhibit 66-NNN(1) is a schedule taken from the books and records of Northwest showing the book value (net asset value) of the common stock of Northwest at the end of each of the months July through December 1961.

74. Attached as Exhibits 67-OOO and 68-PPP, respectively, are copies of a ruling letter transmitted to Pacific and dated June 28, 1961, and a supplemental ruling letter transmitted to Pacific and dated November 15, 1962. These two exhibits are being stipulated for the limited purpose of showing the basis for and scope of such ruling letters.

75. Attached as Exhibits 69-QQQ, 70-RRR, 71-SSS and 72-TTT, respectively, are copies of letters dated February 7, 1961, March 20, 1961, April 27, 1961 and July 6, 1961, submitted to the respondent in connection with the above-stipulated ruling [234] letters. Exhibits 69-QQQ and 71-SSS were submitted on behalf of Pacific. Exhibits 70-RRR and 72-TTT were submitted on behalf of the shareholders of Pacific other than American. In the March 20, 1961 statement of authorities which accompanied Exhibit 70-RRR it was stated that it was contemplated the offering price of the stock of Northwest by way of rights would be in excess of the par value of such stock and of Pacific's basis in such stock at the time such offerings were made and would be less than fair market value of such stock at such time. As noted in Exhibit 71-SSS, Pacific later withdrew the request it had made as item 8 of Exhibit 69-QQQ for a ruling on the effect of the Plan on the earnings and profits of Pacific and of Northwest. These four exhibits are being stipulated for the limited purpose of showing the basis for and scope of such ruling letters.

76. Attached as Exhibit 73-UUU are copies of the following:

(1) a letter dated September 24, 1961, signed by Mr. Robert Stromberg, Chief of the Office of Accounting Sys-

tems of the Federal Communications Commission in 1961, and received by Mr. J. O. Einerman, Vice-President and Comptroller of Pacific; and

(2) Mr. Einerman's response to Mr. Stromberg dated October 2, 1961, received by Mr. Stromberg. It is stipulated that Mr. Stromberg is the Mr. Stromberg mentioned in the three memoranda of conferences in Washington, D.C., which are [235] items (3) and (4) of Exhibit 29-CC to this stipulation.

77. Attached as Exhibit 74-VVV is an affidavit executed by Mr. J. O. Einerman, Vice-President and Comptroller of Pacific. It is hereby stipulated that the statements made by Mr. Einerman in the affidavit may be received in evidence in these proceedings with the same effect as though Mr. Einerman had been called and sworn as a witness and the statements contained in the affidavit had been made in open court under oath.

Dated: December 14, 1964.

[236]

TABLE OF EXHIBITS

*Page references below are to the pages of this Consolidated Appendix, rather than to the pages of the original Consolidated Stipulation of Facts.

EXHIBIT 2-B(1)

ARTICLES OF INCORPORATION OF THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

* * * * *

SIXTH: (a) That the total number of shares which the corporation shall have authority to issue is one hundred five million eight hundred twenty thousand (105,-820,000) of the aggregate par value of one billion five hundred eighty-two million dollars ($1,582,000,000) and of which eight hundred and twenty thousand (820,000) shall be preferred shares of the par value of one hundred dollars ($100) each, and one hundred five million (105,000,-000) shall be common shares of the par value of fourteen and two-sevenths dollars ($14-2/7) each.

(b) The holders of the preferred shares shall be entitled to receive when and as declared, from the surplus profits arising from the business of the corporation, yearly dividends at the rate of six (6) per cent per annum, and no more, payable in monthly, quarterly or semi-annual installments, as the Board of Directors or the By-Laws shall from time to time provide. The dividends on the preferred shares shall be cumulative and shall be declared and paid or set apart before any dividends on the common shares shall be paid or set apart; so that if, at any time, dividends amounting to six (6) per cent per annum shall not have been paid thereon or declared and set apart for all preceding dividend periods, the de-

ficiency shall be declared and paid or set apart before any dividends shall be paid on or set apart for the common shares. Whenever all cumulative dividends on the preferred shares for all previous years shall have been declared and shall have become payable, and the accrued installments for the current year shall have been declared, and the corporation shall have paid such cumulative dividends for the previous years and such accrued installments, or set aside from its surplus or net profits a sum sufficient for the payment thereof, the Board of Directors may declare dividends on the common shares payable out of any remaining surplus profits of the corporation. In the event of any dissolution or winding up (whether voluntary or involuntary) of the corporation, the holders of the preferred shares shall be entitled to be paid out of the surplus profits arising from the business of the corporation and then remaining intact, or, in case such profits be insufficient, then from the general surplus assets of the corporation, the amount of the unpaid dividends, if any, accrued upon such preferred shares and also the full face value of such shares, and after such payments to the holders of the preferred shares the remaining assets and funds shall be divided and paid equally to the holders of the common shares only and according to their respective number of common shares.

(c) The unissued shares may be offered for subscription or sale or in exchange for property and be issued from time to time upon such terms and conditions as the Board of Directors may prescribe; but, when offered for subscription or sale for cash, such shares shall be offered first to the corporation's preferred and common

shareholders, who shall have a preferential right to subscribe for or purchase the shares so offered, in proportion to the aggregate par value of the shares, preferred and or common, held by them respectively, so that the holders of preferred shares shall have for each preferred share held seven (7) times the preferential right that the holders of common shares have for each common share held. In voting at meetings of shareholders and in giving written consent with respect to their shares, the holders of preferred shares shall be entitled to seven (7) votes for each such share held and the holders of common shares shall be entitled to one (1) vote for each such share held. The Board of Directors shall have authority from time to time to set aside from the surplus profits arising from the business of the corporation such a sum for a working capital, to be employed in the business of the corporation, as said Board may determine. The authorized number of shares of the corporation may be increased in the manner provided by law, but any issue of preferred shares shall carry the same rights and preferences as herein provided and designated for preferred shares.

(d) Immediately prior to the time the amendment of this Article SIXTH, as herein provided, becomes effective by filing with the Secretary of State of California a certificate of amendment of the articles of incorporation amending this Article SIXTH (the time such amendment of Article SIXTH so becomes effective being hereinafter in this paragraph called "the time this amendment becomes effective") there were outstanding thirteen million five hundred thirty thousand nine hundred (13,530,900)

common shares of the corporation of the par value of one hundred dollars ($100) per share. Said thirteen million five hundred thirty thousand nine hundred (13,530,900) outstanding common shares are hereinafter in this paragraph referred to as "the old common shares" and the common shares of the par value of fourteen and two-sevenths dollars ($14-2/7) per share as authorized by said amendment are hereinafter in this paragraph referred to as "the new common shares." At the time this amendment becomes effective the old common shares shall be changed into an aggregate of ninety four million seven hundred sixteen thousand three hundred (94,716,300) new common shares, each old common share being changed into seven (7) new common shares. The share certificates representing the thirteen million five hundred thirty thousand nine hundred (13,530,900) common shares issued and outstanding immediately prior to the time this amendment becomes effective shall at the time this amendment becomes effective represent a like aggregate number of common shares of the par value of fourteen and two-sevenths dollars ($14-2/7) each, as the same shall be constituted at the time this amendment becomes effective and the corporation shall issue and deliver to each holder of common shares of the corporation of record immediately prior to the time this amendment becomes effective a certificate representing six (6) additional common shares for each common share issued and outstanding immediately prior to the time this amendment becomes effective and held by each such shareholder at such time. The purpose and effect of this amendment of Article SIXTH with respect to outstanding shares is to change each outstanding com-

mon share of the par value of one hundred dollars ($100) per share into seven (7) common shares of the par value of fourteen and two-sevenths dollars ($14-2/7) per share and to preserve the relative voting power and the pre-emptive rights of the preferred and common shares by providing that each preferred share shall have seven (7) votes and each common share shall have one (1) vote and that shareholders have a preferential right to subscribe for or purchase shares offered for subscription or sale for cash in proportion to the aggregate par value of shares held by them.

(As last amended August 19, 1959)

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Source and Application of Funds of Pacific
for Twelve-month Periods Ended June 30 -- 1954 through 1963
(Thousands of Dollars)

Exhibit 10-J

	1954	1955	1956	1957	1958	1959	1960	Sub-Total 1954 - 1960	1961	1962	1963	Total 1954 - 1963
SOURCE OF FUNDS												
Net telephone operating and other income before depreciation	$116,788	$142,243	$157,303	$189,330	$212,545	$265,228	$295,290	$1,378,727	$308,943	$296,335	$308,634	$2,292,639
Common stock issued #	-	100,102	133,628	155,910	181,896	159,143	143,010	873,690	(1)	-	-	873,689
Debentures issued #	50,811	(2,368)	68,021	78,989	91,243	81,179	72,185	440,061	-	-	-	440,061
Advances from American (Net)	-	-	78,855	135,145	(8,000)	(130,000)	(38,000)	38,000	195,000	(155,000)	107,000	185,000
Bank loans (Net)	78,605	13,330	(75,635)	(91,445)	-	-	-	(75,145)	-	-	-	(75,145
Other	27,021	35,999	45,818	31,918	23,753	18,785	18,083	201,375	20,709	15,305	18,811	256,200
Proceeds from sale of Northwest stock (Gross)	-	-	-	-	-	-	-	-	-	279,136	9,040	288,176
Payment received on Northwest note	-	-	-	-	-	-	-	-	-	49,979	101,318	151,297
Total	273,225	289,306	407,990	499,847	501,437	394,335	490,568	2,856,708	524,651	485,755	544,803	4,411,917
APPLICATION OF FUNDS												
Additions to telephone plant	217,629	229,369	339,861	430,402	383,838	303,900	355,946	2,260,945	385,718	334,480	399,264	3,380,407
Cash dividends to shareholders	48,406	53,671	62,453	72,993	85,290	94,057	115,758	532,628	124,343	129,057	130,628	916,656
Other	7,190	6,266	5,676	(3,548)	32,309	(3,622)	18,864	63,135	14,590	22,218	14,911	114,854
Total	273,225	289,306	407,990	499,847	501,437	394,335	490,568	2,856,708	524,651	485,755	544,803	4,411,917

Net of expenses.

NOTE: Individual items may not cross-add due to rounding.

EXHIBIT 15-O

PRESENTATION OF PLAN

Early last year when we were considering the establishment of a separate operating entity in the Pacific-Northwest, we gave a great deal of study to the possibility of setting up a separate corporation to do the job. There were, however, legal, tax and other problems involved which could not be resolved at that time. We have given a good deal more study to this matter and we believe we have now developed a workable plan for setting up such a corporation.

First, let us consider the basic reasons for dividing Pacific Telephone. I have a few charts here to help present the subject. (Turn to Chart 1) The first is a map of the territory served by the company. We extend from border to border and go 500 to 600 miles in from the coast. All told we cover about one-seventh of the area of the mainland states. Because of our tremendous growth and the increasing complexity of operating so large a territory, we have been forced to subdivide the company into operating areas and we now have two in the Northwest and five in California-Nevada.

(Turn to Chart 2) Now let us look at some figures showing the growth of the company in the postwar period. The population in the states we serve has increased from 12,500,000 to 21,000,000. Our telephones have increased threefold from 2,700,000 to 8,000,000. Telephone plant investment has increased fivefold from $679 million to $3,460 million. Annual operating revenues have in-

creased more than fourfold from $249 million to $1,135 million.

What does the future look like? (Turn to Chart 3) We expect population to exceed 27 million by 1970. We expect to serve more than 10½ million telephones by 1965. We expect plant investment to exceed $5 billion by 1965. We expect annual operating revenues to exceed $1½ billion.

Let's consider the size of the present divisions of the company. (Turn to Chart 4) The Pacific-Northwest division is now as large as the entire Pacific Company at the end of the war. It is 13th in size among the 22 Bell System operating companies. The California-Nevada division is as large as the entire Pacific Company about three years ago. By most measures it is second in size among the Bell System companies.

What advantages did we see in setting up separate operating divisions? (Turn to Chart 5) We believed that top authority would be closer to the communities served. There would be better recognition of the service needs of each community, more flexibility in dealing with customers, closer relations with employees, better understanding by the public and the authorities who regulate us. On the whole we expected more efficient operations.

The Northwest division organization is now complete and is functioning smoothly. We believe that the division setup has worked well. But there are still additional advantages to be achieved from a complete corporate separation. (Turn to Chart 6) Then, financing problems as well as operating problems could be assumed by the Northwest management. A board of directors drawn from the

territory served would have complete responsibility as compared with the advisory functions of the existing groups. Pacific's top management could then concentrate its full attention on the problems of California and Nevada.

The plan being presented for approval contemplates the formation of a new company, to be incorporated in the State of Washington with headquarters at Seattle. On or about July 1st of this year, Pacific would transfer the assets and liabilities carried on its books applicable to the States of Washington, Oregon and Idaho to the new company and receive in return all of the new company's securities. The initial capitalization of the new company would be in approximately the same proportions of debt, stock and surplus as now exist for Pacific. Let's see how this would work out in actual figures. (Turn to Chart 7) As of June 30, 1961, it is estimated that Pacific will have net assets of $2,945 million. The capital invested in these assets will comprise $902 million of debentures, $237 million of advances from American, $82 million of preferred stock, $1,497 million of common stock, and $227 million of earned surplus. (Turn to Chart 8) Immediately after the transfer, the new company would have net assets of $583 million. It is contemplated that it would give to Pacific in return for these assets $200 million of debt obligations and $340 million of common stock. By keeping the total face amount of these securities at $540 million, the new company would be able to set up $43 million as a paid-in surplus account, this amount being roughly proportionate to the size of Pacific's surplus before the transfer. Pacific's accounts after the transfer would differ

from what they were before in several respects. In place of the assets transferred they would now include the investment in the new Company's securities and earned surplus would be reduced by the amount of surplus paid in to the new company.

As soon as possible after the transfer date, it is proposed that Pacific will offer for sale about $190,000,000 par value or approximately 56% of the common stock of the new company. The holders of Pacific's common shares will be given rights to purchase this stock on the basis of a pro-rata offering entirely to such holders. The holders of Pacific's preferred shares, other than the American Company, will also be given rights to purchase such stock in the number they would have been entitled to receive if the offering were being made pro rata to all holders of common and preferred shares. The rights received by the preferred shareholders will come from the waiver by the American Company of rights with respect to a portion of its holdings of Pacific's common shares. We have already received assurance from American that they will waive sufficient rights so that this offer can be made to the preferred shareholders.

The proceeds received by Pacific from the sale of the new company's shares will be used to repay all or most of its then outstanding advances from American. I should mention here the reasons for selling about 56% of the new company's shares rather than mere or less. First, the sale of at least this amount will enable American, by exercising its rights to purchase shares, to acquire more than 50% control of the new company and relieve Pacific of

the responsibility for such control, thus achieving a primary objective of the plan. Second, by selling no more than this, Pacific will obtain the amount of cash it needs to pay off its advances from American but will not have excess cash left over which would have to be invested temporarily at a low return. The plan contemplates that Pacific will dispose of the balance of the shares by one or two subsequent offerings timed to meet its needs for additional capital. On the last offering, it is expected that American will agree to purchase any shares unsubscribed by other shareholders so that Pacific may end up with no investment in the new company.

We have given a good deal of consideration to the price at which the new company's shares will be offered. The situation differs from that we have had before where the company was offering additional shares of Pacific's own stock. Here, the company will be offering to sell to its shareholders stock of a subsidiary company; in effect, it will be selling a portion of its assets. When you sell an asset the normal tendency is to sell at the highest price possible so as to protect the interests of the debenture holders, preferred shareholders and others. At the same time, the higher the price the more taxes we may have to pay on the excess of selling price over book value. A lower price would produce higher rights values and should result in a broader distribution of the stock among our shareholders. Even here, higher rights values may not be popular with some of our shareholders because they may be ruled to be taxable income, as opposed to rights to our own shares which generally receive capital gains treatment.

We shall not have to reach a decision as to the selling price until just before the date of each offering, the first of which will probably be made in September. For the purpose of the press release to be issued today, we propose to say that the price will be fixed by the Board of Directors and that it is expected to be in excess of the par value of the new stock.

Determining the price in this manner will mean that the proceeds will exceed the book value of the new company's shares. Such excess will be credited to Pacific's surplus and should equal or exceed the charge of $42 million made at the time of the transfer.

With regard to the new company's debt obligations which Pacific will accept at the date of the transfer, it is contemplated that they will be outstanding no longer than about three years and will bear a rate of interest not exceeding the average rate on Bell System company debenture issues sold to the public shortly before the time of transfer. It is also contemplated that the new company will refund these obligations by bond issues sold publicly at competitive bidding timed to meet Pacific's needs for additional capital. It is expected that the new company will sell its first bond issue about six to nine months after the transfer and follow with additional issues at 9 to 12 month intervals. It is contemplated that the complete sale of the new company's securities, both stock and debt, will satisfy Pacific's new capital requirements for its construction program in California and Nevada for 3 to 4 years after the transfer date. The new company will secure its needs for new capital during this period by ob-

taining advances from American, which advances will be repaid from the proceeds of permanent financing at the end of the period.

In transferring the business and properties of Pacific in Washington, Oregon and Idaho to the new company, the objective will be to put the new company as nearly as possible in the situation it would have been in if the telephone business in such states had at all times been conducted by the new company. Thus, at the time of transfer, the new company would enter into contractual arrangements with other Bell System companies in the same form as Pacific now has with such companies. The contracts would include a License Contract with American, a Standard Supply Contract with Western Electric Co. and a Division of Revenues Contract covering interstate and foreign services furnished by Bell System companies.

The new company would provide the same benefits to its employees as now exist for Pacific. The Pension Trust of the new company would be set up initially by transferring an actuarially determined portion of Pacific's Pension Trust to the new company applicable to employees of the new company and to pensioners who, at the time of their retirement, were employees of Pacific in Washington, Oregon and Idaho. The new company would assume existing contracts with the unions covering employees of the company in these states.

The consummation of the entire plan would depend on rulings by the Internal Revenue Service that the establishment of the new company will constitute a tax-free reorganization and that the Pension Trust of the new

company will be a qualified trust under the provisions of the income tax laws. Without favorable rulings on these two matters, the carrying out of the plan would not be feasible. A ruling would also be sought on the tax status of the rights received by Pacific's shareholders other than American to purchase the new company's shares. Taxable income to the holders of such shares might result with respect to such rights, since they would differ from the rights granted by a company for the purchase of its own shares.

Numerous approvals would have to be obtained from the Washington, Oregon and Idaho state commissions and the Federal Communications Commission. These will include approvals covering the purchase and sale of properties, the issuance of new securities and the new contractual arrangements.

If the Directors approve this proposal, we plan to proceed with the following schedule. (Turn to Chart 9) We shall immediately forward preliminary proxy material to the S.E.C. for their review. We shall have preliminary discussions with the regulatory commissions and public authorities later today. Late today we shall make public announcement of the plan.

We shall apply to the Internal Revenue Service for the necessary tax rulings by the middle of February. The proxy statement will be mailed to shareholders on February 27 and we would expect the plan to be approved at the annual meeting on March 24. We would then incorporate the new company and Pacific and the new company would jointly make applications to the regulatory com-

missions for all of the required approvals. We hope to have the commission approvals and tax rulings in hand by June 30th so that the transfer of property can be made on July 1.

On this basis the first offering to Pacific's shareholders of the new company shares would come during September. The sale of the first debt issue by the company might be in March 1962. The dates of the second offering of shares and the second issue of debt are shown here as December 1962 and March 1963 but they are very tentative and the dates of the third offering and issue are even more tentative. But they give you some idea of the over-all extent of the plan.

POSTWAR GROWTH (2)

POPULATION

From 12,500,000 to 21,000,000

TELEPHONES

Threefold increase from 2,700,000 to 8,000,000

PLANT INVESTMENT

Fivefold increase from $679 million to $3,460 million

OPERATING REVENUES

Fourfold increase from $249 million $1,135 million

LOOKING AHEAD (3)

POPULATION

To exceed 27 million by 1970

TELEPHONES

To exceed 10½ million by 1965

PLANT INVESTMENT

To exceed $5 billion by 1965

OPERATING REVENUES

To exceed $1½ billion by 1965

THE DIVISIONS (4)

PACIFIC-NORTHWEST

As large as entire Pacific Company at end of war.

13th in size among 22 Bell System Companies

CALIFORNIA-NEVADA

As large as entire Pacific Company about three years ago.

2nd in size among 22 Bell System Companies.

ADVANTAGES OF SEPARATE DIVISIONS (5)

Top authority closer to communities served.

Better recognition of service needs of each community.

More flexibility in dealing with customers.

Closer relations with employees.

Better understanding by public and authorities.

More efficient operations.

ADDITIONAL ADVANTAGES OF SEPARATE COMPANIES (6)

Financing problems, as well as operating problems, will be assumed by Pacific-Northwest management.

A Board of Directors with final authority, drawn from the territory served, in place of the present advisory boards.

Pacific Company management can concentrate full attention to needs of California and Nevada.

ESTIMATED AS OF 6/30/61

	Pacific
Plant Investment	$ 3,593
Depreciation Reserve	650
	2,943
Current Assets	204
Total Assets	3,147
Current Liabilities	225
Net Assets	2,922
Debentures	902
Notes	230
Preferred Stock	82
Common Stock	1,497
Surplus	211
Total Capital	2,922

ESTIMATED AS OF 7/1/61

	New Company	Pacific
Plant Investment	$ 702	$2,891
Depreciation Reserve	140	510
	562	2,381
Investment in New Company		535
Current Assets	42	162
Total Assets	604	3,078
Current Liabilities	27	198
Net Assets	577	2,880
Debentures		902
Notes	200	230
Preferred Stock		82
Common Stock	335	1,497
Surplus	42	169
Total Capital	577	2,880

TENTATIVE SCHEDULE

(9)

	Date
Board of Directors' authorization	1/27/61
Preliminary proxy material to S.E.C.	1/27/61
Discussions with commissions and public authorities	1/27/61
Public announcement of proposed plan	1/27/61
Application to Internal Revenue Service for Federal income tax rulings	by 2/15/61
Proxy statement mailed to shareholders	2/27/61
Approval of plan at Annual Meeting	3/24/61
Incorporation of new company	3/27/61
Applications to commissions for all regulatory approvals	3/31/61
Receipt of commission approvals and tax rulings	by 6/30/61
Transfer of property to new company	7/1/61
First offering by Pacific of new company's stock	Sept. 1961
Sale of first debt issue by new company	Mar. 1962
Second offering by Pacific of new company's stock	Dec. 1962
Sale of second debt issue by new company	Mar. 1963
Last offering by Pacific of new company's stock	Dec. 1963
Sale of third debt issue by new company	Mar. 1964

EXHIBIT 17-Q

THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY

140 New Montgomery Street, San Francisco 5
Area Code 415
GA 1 - 9000

C. O. Lindeman
President

February 27, 1961

DEAR SHAREHOLDER:

The Directors of your Company have concluded that there would be important advantages to your Company, to its shareholders and to the users of its services if the present business and properties of the Company were divided so that your Company and its present subsidiary, Bell Telephone Company of Nevada, would operate in the States of California and Nevada, and a separate company would conduct the operations in the States of Oregon, Washington and Idaho. As you will see from the accompanying notice, a plan for the reorganization of your Company along these lines is one of the matters to be considered at the Annual Meeting of Shareholders. This plan, which is described in detail in the accompanying proxy statement, contemplates that a new company would be established to acquire the business and properties of the Company in the States of Oregon, Washington and Idaho. The new company initially would be a subsidiary of the Company but as soon as practicable more than half of the capital stock of the new company would be offered for sale to the shareholders of the Company. The remainder of the capital

stock of the new company would be offered for sale to the shareholders of the Company at a subsequent date or dates.

Since World War II there has been a tremendous increase in the demand for telephone service in the area served by the Company. The number of telephones has increased almost threefold from 2,700,000 to about 8,000,000 today; the investment in telephone plant (without deducting the depreciation reserve) has increased more than fivefold from $679,000,000 to $3,459,000,000; and annual operating revenues have increased more than fourfold from $249,000,000 to $1,136,000,000. Present operations in California and Nevada, in terms of plant investment and operating revenues, exceed those of the entire Company in 1957. The operations in Oregon, Washington and Idaho almost equal those for the entire Company at the end of World War II.

Growth in the Pacific Coast states continues at a rapid pace. Recent studies predict that the population of California will increase from about 16,100,000 at present to more than 20,000,000 in 1970. Large population increases are also expected in the other states.

In view of the increasing magnitude and complexity of operations, particularly looking to the future, the management of the Company believes there would be important advantages, including greater efficiency in operations, in operating the business in California and Nevada through the Company and its present subsidiary, Bell Telephone Company of Nevada, and in having the business in Oregon, Washington and Idaho operated through a separate

company as proposed in the plan. This would mean bringing top authority closer to the communities served, better recognition of the service needs of each community, more flexibility in dealing with customers, closer relations with employees and better understanding and acceptance by the public.

Early in 1960 a new division of the Company was created to conduct operations in Oregon, Washington and Idaho. This has worked well, and the management believes that even greater benefits will be derived through the complete corporate separation which the plan would effect.

Management recommends a vote FOR the plan for reorganization.

Yours very truly,

C. O. Lindeman

President

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PLAN FOR REORGANIZATION

The plan for reorganization (hereinafter called the "Plan") to be considered and voted on at the annual meeting is designed to divide the present business and properties of the Company so that the Company will confine its operations to California and a new company organized for the purpose (hereinafter referred to as the "New Company") will conduct the business formerly carried on by the Company in Oregon, Washington and Idaho. The Company will continue to operate in Nevada through its subsidiary, Bell Telephone Company of Nevada.

Summary of the Plan

The New Company will acquire the business and properties of the Company in the States of Oregon, Washington and Idaho in consideration for the issuance to the Company by the New Company of its capital stock and debt obligations in such amounts that the New Company will have capital stock, debt obligations and surplus in substantially the same proportion as the Company. Contractual arrangements of the kind the Company now has in effect with other Bell System Companies will be made by the New Company. The objective will be to put the New Company as nearly as possible in the situation it would have been in if the business in the States of Oregon, Washington and Idaho had at all times been conducted by the New Company.

Promptly after the Company acquires the securities of the New Company, about $190,000,000 par value of the capital stock of the New Company (approximately 56 per cent of such stock) will be offered for sale to the holders of the common shares of the Company, and to the holders of the preferred shares of the Company other than the American Company. The rights to purchase stock of the New Company received by such holders of preferred shares will come from rights which the American Company would otherwise receive with respect to its common shares. The proceeds from such sale of stock of the New Company will be used by the Company to repay outstanding advances from the American Company, which were $134,000,000 at December 31, 1960 and are expected to be about $225,000,000 by June 30, 1961. At a time or times related to its need for new capital, the Company will of-

fer the remainder of the shares of the New Company for sale in a similar manner to shareholders of the Company.*

In order to consummate the Plan it will be necessary to obtain the approval of various regulatory authorities. The Plan is also subject to the favorable vote of a majority of the voting power of the Company. The American Company which holds 89.62% of the voting power of the Company has advised that it intends to vote in favor of the Plan. Even after such approvals, however, the Plan may be abandoned if prior to the transfer of the properties the Board of Directors of the Company should determine that it is not in the best interests of the Company and the shareholders to consummate the Plan.

The New Company

The New Company will be organized pursuant to the laws of the State of Washington and will have its principal office in Seattle. The New Company will acquire, in consideration for the issuance to the Company of the securities described under the caption "Securities to be Issued by New Company," all of the business and properties of the Company existing at the time of such acquisition in the States of Oregon, Washington and Idaho, including plant, cash, accounts receivable, material and supplies, franchises, easements, rights-of-way, licenses and leases. The New Company will assume all outstanding liabilities existing at the time of such acquisition relating to the

*To the extent the needs of the Company for new capital are met by use of the proceeds from sales of the capital stock of the New Company or from payment of the debt obligations of the New Company it will be unnecessary for the Company to sell its own securities.

business of the Company in such states, except liabilities with respect to any dividends declared on stock, income taxes for which liability reserves have been established, and principal of and interest on debentures and short-term debt of the Company.

At the time of the transfer the New Company will enter into contractual arrangements with other companies of the Bell System in substantially the same form as the contractual arrangements which the Company has with such companies, the intention being that the New Company will continue the operations in the States of Oregon, Washington and Idaho pursuant to the same kind of contractual arrangements as have existed in the past. Such contractual arrangements will include a License Contract with the American Company, a Standard Supply Contract with Western Electric Company, Incorporated, and arrangements covering the sharing of revenues from interstate and foreign service furnished by the companies of the Bell System.

A Plan for Employees' Pensions, Disability Benefits and Death Benefits, and a related Pension Trust Agreement with Bankers Trust Company, Trustee, in the same form as the Pension Plan and related Pension Trust Agreement of the Company, will continue the same benefits for the employees of the New Company as they had before. There will be transferred to the Pension Fund of the New Company from the Pension Fund of the Company the portion of the Pension Fund of the Company, actuarially determined, applicable to employees employed in the States of Oregon, Washington and Idaho at the time of the transfer of the properties and to persons who at the

time of their retirement were employees of the Company in these states.

The New Company will assume existing contracts with the unions covering employees of the Company in the States of Oregon, Washington and Idaho. Working practices and other conditions of employment will not be affected by the transfer of the properties.

It is expected that membership on the Board of Directors of the New Company will consist predominantly of representative citizens residing in the area in which the New Company will operate, including persons now serving the Company in an advisory capacity. It is also expected that one or more officers of the New Company and an officer of the American Company will serve on the Board. The officers of the New Company will consist for the most part of officers of the Company who now hold positions in the Pacific-Northwest division of the Company.

Securities to be Issued by New Company

The New Company, in consideration for the transfer to it of the business and properties of the Company in the States of Oregon, Washington and Idaho, will issue to the Company par value of capital stock (common) and aggregate principal amount of debt obligations in a total amount which will bear substantially the same relationship to the net book cost of the assets transferred and liabilities assumed as the total of the par value of the stock (common and preferred) and the aggregate principal amount of the debt obligations of the Company bears to the net book cost of all its assets less liabilities before

the transfer. The par value of capital stock, debt obligations and surplus of the New Company will be in substantially the same proportions as the par value of stock (common and preferred), debt obligations and surplus of the Company before the transfer.

If the transfer were to be made as of June 30, 1961, it is estimated that assets and liabilities carried on the books of the Company at a net book cost of approximately $577,000,000 would be transferred to the New Company and that the capitalization of the New Company after the transfer would be approximately as follows:

Capital Stock	$335,000,00
Debt Obligations	200,000,000
Surplus	42,000,000
	$577,000,000

The shares of capital stock of the New Company will all have equal voting rights and will be entitled to participate equally in dividends and to share equally on liquidation. The holders of the stock will have pre-emptive rights as to additional issues of such stock. They will also have the right to vote cumulatively at elections for directors, as provided by the law of the State of Washington.

The debt obligations issued by the New Company at the time of transfer will bear such rate of interest as shall be agreed upon by the Company and the New Company. It is anticipated that these obligations will be outstanding no longer than about three years and that the rate of interest on such obligations will not exceed the average rate of interest on debenture issues sold to the public by companies of the Bell System shortly before the time of transfer of assets.

During the period of about three years required by the Company to dispose of the capital stock of the New Company and by the New Company to refund the debt obligations issued at the time of the transfer, it is intended that the New Company will finance its construction program by advances from the American Company.

Offerings of Stock of the New Company to Shareholders of the Company

Promptly after acquiring the securities of the New Company, the Company will offer for sale about $190,000,000 par value of the capital stock of the New Company (approximately 56% of such stock) on the following basis. The holders of record, on a date to be specified, of the common shares of the Company will receive rights to purchase such stock on the basis of a pro rata offering entirely to such holders, subject to the following provisions. The holders of record on such date of the preferred shares of the Company (other than the American Company) will receive rights to purchase stock of the New Company on the basis that each such holder of preferred shares, for each preferred share held, will receive seven times the number of rights to purchase such stock that holders of common shares will receive for each common share held. The rights to participate received by such holders of preferred shares will come from rights which the American Company would otherwise receive with respect to its common shares. The proceeds from such sale of stock of the New Company will be used by the Company to repay outstanding advances from the American Company, which are expected to be about $225,000,000 by June 30, 1961.

It is expected that within about three years after acquiring the stock of the New Company, the Company by one or more offerings will offer for sale the balance of such stock, following the procedures described in the preceding paragraph. The proceeds from such sales will be used by the Company to repay advances then outstanding and for general corporate purposes including expenditures for extensions, additions and improvements to its telephone plant.

The prices at which the shares of the New Company will be offered pursuant to the offerings referred to in the two preceding paragraphs will be determined by the Board of Directors of the Company at the time of each offering. It is expected that in each case the offering price will be in excess of the par value of the new stock. It is also expected that the offerings will not be underwritten. In connection with the final offering, shares not sold upon the exercise of rights may be sold by the Company to the American Company at the offering price.

It is expected that the American Company will exercise its rights to purchase stock of the New Company in each of the offerings.

Disposition of Debt Obligations of the New Company

It is intended that the New Company will sell an issue of debentures to the public, within six to nine months after the transfer of the properties, for the purpose of refunding a portion of the debt obligations issued to the Company at the time of the transfer of assets. It is also intended that during the period of about three years after

the transfer the New Company will sell additional debentures to the public for the purpose of refunding the remainder of such debt obligations. The proceeds received by the Company from such refundings will be used to repay advances then outstanding and for general corporate purposes including expenditures for extensions, additions and improvements to its telephone plant.

Plan Subject to Approval of Regulatory Authorities

The Plan is subject to the issuance by the Public Utility Commissioner of the State of Oregon and the Public Service Commission of the State of Washington of appropriate orders approving the Plan and approving all transactions required for the consummation of the Plan which are within the respective jurisdictions of such authorities. Included among the orders required will be orders approving the transfer of assets from the Company to the New Company, the initial issue of securities by the New Company in consideration for such assets, and the making of contractual arrangements between the New Company and other companies of the Bell System of the kind hereinbefore referred to. Approval of the Public Utilities Commission of Idaho will be required for the discontinuance by the Company of business in that State. Approval of the Federal Communications Commission will be required for the discontinuance by the Company of operations in Oregon, Washington and Idaho, for the acquisition by the New Company of the interstate lines in such states and for the accounting to be followed by the New Company.

Plan Subject to Approval of Shareholders

The Board of Directors of the Company has approved the Plan and has directed that it be submitted to the shareholders for approval by a majority of the voting power of the Company. The American Company which holds 89.62% of the voting power of the Company has advised that it intends to vote in favor of the Plan.

Income Tax Rulings

In the opinion of counsel for the Company the transfer of properties to the New Company and the issuance by the New Company of securities in consideration for such transfer will constitute a tax-free transaction under the Federal income tax laws. A ruling to this effect is being requested from the Internal Revenue Service. Similar rulings are being requested from state authorities in connection with the application of state income tax laws.

A ruling is also being requested from the Internal Revenue Service with respect to the qualification and exemption under the provisions of the Federal tax laws of the pension plan and related trust of the New Company.

If the price at which the stock of the New Company is sold exceeds the tax basis of such stock to the Company, state taxes measured by income may be payable by the Company on the excess and a Federal income tax will be payable on a portion of such excess. Rulings are being requested with respect to these matters. The amount of any such taxes cannot be determined at this time.

A ruling is also being requested from the Internal Revenue Service with respect to the tax status of the rights to purchase which will be issued in connection with the offerings of capital stock of the New Company to shareholders of the Company other than the American Company. Taxable income to the holders of such shares may result with respect to such rights, which rights differ from the rights granted by a corporation to its shareholders for the purchase of its own stock.

Expenses of the Plan

It is anticipated that the expenses to be incurred in the establishment of the New Company and the transfer of properties to it will amount to about $800,000. Additional expenses will be incurred in issuing the New Company's securities which will be substantially in the same amount and of the same kind as expenses which would have been incurred if during the period the Company had been required to issue its own securities to raise new capital.

* * * * *

EXHIBIT 27-AA

Copy of Promissory Note of Northwest
Dated June 30, 1961, Payable to Pacific

Seattle, Washington
June 30, 1961

On demand, for value received, the undersigned promises to pay to the order of THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY Two Hundred Million Dollars ($200,000,000) at the office of the Treasurer of said The Pacific Telephone and Telegraph Company, 140 New Montgomery Street, San Francisco, California, with interest at the rate of 4½ per cent per annum, payable monthly, from date until paid.

PACIFIC NORTHWEST BELL TELEPHONE
COMPANY

	John H. Page		W. W. Straley
(Sgd)	Treasurer	(Sgd)	President

EXHIBIT 28-BB

PACIFIC NORTHWEST BELL TELEPHONE COMPANY

BALANCE SHEET—COMMENCEMENT OF BUSINESS JULY 1, 1961

ASSETS	Thousands of Dollars
PLANT AND OTHER INVESTMENTS:	
Telephone Plant—Note (a):	
Telephone Plant in Service	$696,207
Telephone Plant under Construction	8,436
Other (principally Property Held for Future Telephone Use)	69
	704,712
Less: Depreciation Reserve	138,205
	566,507
Other Investments (principally real estate)	286
	566,793
CURRENT ASSETS:	
Demand Deposits	458
Special Cash Deposits	34
Working Funds Advanced to Employees	99
Accounts Receivable (including accrued items) from:	
Customers and Agents (less Reserve for Uncollectibles, $190,000)	22,607
Others	5,871
Material and Supplies—Note (b)	1,904
	30,973
PREPAYMENTS AND DEFERRED CHARGES:	
Prepayments:	
Telephone Directory Expense	3,851
Taxes	50
Other	730
Deferred Charges	2,166
	6,797
TOTAL ASSETS	$604,563

PACIFIC NORTHWEST BELL TELEPHONE COMPANY

BALANCE SHEET—COMMENCEMENT OF BUSINESS JULY 1, 1961

LIABILITIES	Thousands of Dollars
CAPITAL STOCK EQUITY:	
Common Stock—par value \$11 per share; authorized 50,000,000 shares; outstanding 30,460,000 shares—Note (c)	\$335,060
Retained Earnings—Note (d)	41,986
Less: Capital Stock Expense	417
	376,629
DEMAND NOTE (4½%)—Note (e):	
Payable to The Pacific Telephone and Telegraph Company, parent	200,000
CURRENT LIABILITIES:	
Advance Billing and Customers' Deposits	6,069
Accounts Payable to:	
The Pacific Telephone and Telegraph Company, parent	377
Western Electric Company, Incorporated, affiliate	10,314
Employees—Payrolls	2,325
Others	996
Taxes Accrued	5,935
Other Current Liabilities	1,338
	27,854
DEFERRED CREDITS	580
TOTAL LIABILITIES	\$604,563

The appended notes are an integral part of this balance sheet.

Notes to Balance Sheet

(a) As required by the Uniform System of Accounts, Telephone Plant is stated at its original cost when first dedicated to the public use. The amounts shown do not purport to represent reproduction cost or present value.

Practically all of the materials purchased for the construction and maintenance of telephone plant, other than buildings, were obtained from Western Electric Company, Incorporated, an affiliate. (See "Standard Supply Contract" under "Certain Contracts".) Western has a substantial investment in manufacturing and other facilities which are devoted mainly to its business with affiliated telephone companies, and its profits on business with these companies constitute its return on the investment devoted to such business. It is impossible to identify the particular purchases from Western over a long period of years which were charged to the plant accounts and now remain therein, but Pacific Northwest Bell considers that such purchases probably represent about 55% to 60% of its total plant investment. Western advises that its rate of profit has varied by years and by classes of sales but that its total profit (after taxes) attributable to all sales of materials and services to affiliated telephone companies (including items chargeable to other than plant accounts) has been approximately 4¼% of such sales over the twenty-five year period ended December 31, 1960 and over the five year period then ended. It is considered that Western's profit ratio on those items which have been charged to the plant accounts is somewhat higher than its profit ratio on total sales to such companies.

(b) New material is carried in this account at cost, reusable material at original cost, estimated if not known, and other material at estimated salvage value. Cost is determined on the basis of average costs, except that specific costs are used in the case of large individual items.

(c) All of the outstanding shares are now owned by the Pacific Company. None of the authorized shares is reserved for officers and employees, or for options, warrants, conversions or other rights.

(d) See second paragraph under "Regulation and Rates" as to proposed revisions in depreciation rates. If such revisions are made, Retained Earnings will be reduced by about $900,000; the resulting tax reduction will be reflected on the books of the Pacific Company which remains liable for income taxes applicable to past periods (see third paragraph of the "General Note to Financial Statements"). The Depreciation Reserve will be increased by the amount of the reduction in Retained Earnings.

(e) See "The Plan for Reorganization of the Pacific Company".

EXHIBIT 30-DD

PROSPECTUS

PACIFIC NORTHWEST BELL TELEPHONE COMPANY

17,459,490 SHARES OF COMMON STOCK

(Par Value $11 Per Share)

These shares are being offered for sale by The Pacific Telephone and Telegraph Company (the "Pacific Company") to its shareholders pursuant to a plan described on pages 3 through 5 of this Prospectus. Under this plan which was approved by the shareholders of the Pacific Company at the annual meeting on March 24, 1961, the Pacific Company transferred to Pacific Northwest Bell Telephone Company ("Pacific Northwest Bell") on June 30, 1961 the business and properties of the Pacific Company in the States of Washington, Oregon and Idaho.

The Pacific Company now owns of record and beneficially all of the 30,460,000 shares of outstanding Common Stock of Pacific Northwest Bell (the only authorized class of stock). The shares offered hereby constitute about 57% of such shares. Under the plan the balance of the 30,460,000 shares not sold pursuant to this offering will be offered for sale later by the Pacific Company to its shareholders [see page 117].

Each shareholder of the Pacific Company of record at the close of business on September 20, 1961 will be given an assignable Warrant evidencing the total number of Rights to purchase the Common Stock offered hereby to which his shareholdings on that date entitle him—one Right for each common share ($14-2/7 par value) held and seven Rights for each preferred share ($100 par

value) held [see page 117 as to reduced participation of American Telephone and Telegraph Company].

PRICE: $16 PER SHARE

Six Rights and payment of $16 will be required for each share of Common Stock purchased. The procedures to be followed in the purchase of shares of Common Stock and in the purchase, sale or transfer of Rights are explained on pages [111-114] of the Prospectus. **The Rights will expire on October 20, 1961 if not used on or before that date.**

Purchasers of the shares will not receive the dividend of $.22 per share which has been declared by Pacific Northwest Bell payable on September 29, 1961 to its shareholder of record on September 8, 1961.

It is expected that American Telephone and Telegraph Company will purchase the Common Stock offered to it under the present offering and will then own directly approximately 51% of the outstanding Common Stock of Pacific Northwest Bell.

THESE SECURITIES HAVE NOT BEEN APPROVED OR DISAPPROVED BY THE SECURITIES AND EXCHANGE COMMISSION NOR HAS THE COMMISSION PASSED UPON THE ACCURACY OR ADEQUACY OF THIS PROSPECTUS. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.

The offering is not underwritten. Shares with respect to which Rights are not exercised will not be sold under the offering. None of the proceeds from the sale of the shares offered will be received by Pacific Northwest Bell.

Application has been made to have the Rights admitted to dealings on the American Stock Exchange and on the Pacific Coast Stock Exchange and to have the Common Stock of Pacific Northwest Bell listed on these Exchanges.

Correspondence relating to this offer should be addressed to Dean Anderson, Treasurer, The Pacific Telephone and Telegraph Company, P.O. Box 3825, Rincon Annex, San Francisco 19, California.

Dated September 13, 1961.

RIGHTS AND WARRANTS AND THEIR USE

Rights and Warrants

Rights are evidenced by assignable Warrants which are being issued to shareholders of The Pacific Telephone and Telegraph Company.

Six Rights and payment of $16 will be required for each share of Common Stock purchased (see "Purchase and Payment for Stock" below). No fractional shares will be issued.

A holder desiring to divide a Warrant may mail it to Dean Anderson, Treasurer, The Pacific Telephone and Telegraph Company, P.O. Box 3825, Rincon Annex, San Francisco 19, California, or to Irving Trust Company, One Wall Street, New York 15, New York, and there will be issued in exchange new Warrants aggregating the same number of Rights, divided as the holder may direct.

Expiration of Offer

Rights will expire on October 20, 1961 if not used on or before that date.

Purchase and Payment for Stock

To purchase stock, Form 1 on the Warrant should be filled in and signed and the Warrant should be mailed or delivered so as to be received on or before October 20, 1961. If mailed it should be addressed to Dean Anderson, Treasurer, The Pacific Telephone and Telegraph Company, P. O. Box 3825, Rincon Annex, San Francisco 19, California. If purchase is made otherwise than by mail, the Warrant should be presented at the office of the Pacific Company, 140 New Montgomery Street, San Francisco, California, or at the office of Irving Trust Company, One Wall Street, New York, New York. In each case, the Warrant must be accompanied by full payment—$16 for each share being purchased.

Checks, drafts and money orders for all payments should be payable to The Pacific Telephone and Telegraph Company. They must be drawn on institutions located in the United States and must be payable in United States dollars.

Certificates for shares purchased will be delivered as soon as practicable after payment of the purchase price.

Purchase and Sale of Rights

Rights may be purchased or sold through the usual investment channels. For the convenience of shareholders, the Pacific Company has entered into an arrangement under which Wells Fargo Bank American Trust Company, San Francisco, will act as Rights Agent to execute orders to buy or sell Rights. The Warrants contain forms for use in this connection. Under this arrangement orders

for the purchase or sale of Rights received by the Rights Agent up to 12 o'clock noon on each day during which the Rights Agent is open for business (to and including October 20, 1961), together with orders received after 12 o'clock noon on the preceding day during which the Rights Agent was open for business, will be executed at the average price (before any commissions paid) of the Rights Agent's market transactions on the later day (whether made before or after 12 o'clock noon and whether made on a stock exchange or otherwise), minus, in the case of selling orders, and plus, in the case of buying orders, a pro rata portion of any commissions which it paid on such market transactions. Orders accepted after 12 o'clock noon on October 20, 1961 will be executed at the average price (before any commissions paid) of the Rights Agent's market transactions with respect to such orders (whether made on a stock exchange or otherwise), similarly adjusted for commissions paid. Buying and selling orders may be offset by the Rights Agent but such orders will be executed at prices determined as outlined above.

The Rights Agent will make a service charge of 2¢ per Right for handling orders. The Pacific Company has agreed that, in the event that the aggregate amount received by the Rights Agent from these charges with respect to all of its transactions is inadequate to cover the estimated cost of its services, the Pacific Company will reimburse the Rights Agent for the deficiency up to a specified amount.

Transfer of Rights Other Than Through the Rights Agent

Rights may be sold otherwise than through the Rights Agent, or may be transferred to others, by filling in and signing Form 3 on the Warrant.

Federal Transfer Tax

There is no Federal transfer tax on the sale or transfer of the Rights.

Correspondence

Correspondence relating to the offer should be addressed to Dean Anderson, Treasurer, The Pacific Telephone and Telegraph Company, P. O. Box 3825, Rincon Annex, San Francisco 19, California.

Tax Status of Rights

The Pacific Company requested a ruling from the Internal Revenue Service on the income tax status of the Rights. Such a ruling has been received and provides the following: (1) the receipt by a shareholder of the Pacific Company of Rights to purchase shares of stock of Pacific Northwest Bell will not result in taxable income to the shareholder; (2) no taxable income will result to such shareholder if the Rights are held until expiration and are not exercised, sold or exchanged; (3) the full amount realized by such shareholder upon a sale or exchange of Rights will constitute ordinary income; (4) the exercise of the Rights by a shareholder which is not a corporation will result in dividend income in an amount equal to the excess of the fair market value of the stock of Pacific Northwest Bell at the time of exercise of the Rights over

the amount paid for the stock; (5) the exercise of the Rights by a shareholder which is a corporation will result in dividend income in an amount equal to the excess, if any, of the basis of the stock of Pacific Northwest Bell in the hands of the Pacific Company at the time of the exercise of the Rights over the amount paid for the stock. The Pacific Company considers that under the ruling the exercise of the Rights by a shareholder which is a corporation will not result in taxable income to such shareholder.

The Pacific Company has filed with the Internal Revenue Service a request for reconsideration of the portion of the ruling referred to in (4) above. The Internal Revenue Service has not yet acted on this request.

THE PLAN FOR REORGANIZATION OF THE PACIFIC COMPANY

The Pacific Company is a subsidiary of American Telephone and Telegraph Company (sometimes referred to herein as the "American Company") which owns of record and beneficially 94,542,139 common shares (90.25%), and 640,957 preferred shares (78.17%) of the Pacific Company. The Pacific Company for many years has carried on a communications business in California and, prior to July 1, 1961, in Washington, Oregon and the northern portion of Idaho. Its subsidiary, Bell Telephone Company of Nevada, for many years has carried on a communications business in Nevada.

At the annual meeting held on March 24, 1961, the shareholders of the Pacific Company approved a plan to divide the business and properties of the Pacific Com-

pany, under which plan a new company, to be organized for the purpose, would own and operate the business in Washington, Oregon and Idaho. In terms of plant investment, operating revenues and net operating income, the business in such States constituted approximately 20% of the business of the Pacific Company. Pacific Northwest Bell Telephone Company was incorporated under the laws of the State of Washington on March 27, 1961, and the Pacific Company purchased for cash 10,000 shares of Pacific Northwest Bell's Common Stock at the aggregate par value of $110,000. The principal offices of Pacific Northwest Bell are at 1200 Third Avenue, Seattle 1, Washington.

The transfer of the business and properties in Washington, Oregon and Idaho was made to Pacific Northwest Bell as of 11:59 P. M. on June 30, 1961, following approval of such transfer by various regulatory authorities. As provided in the plan Pacific Northwest Bell assumed the liabilities of the Pacific Company in connection with the business in Washington, Oregon and Idaho, except liabilities with respect to dividends declared on stock, income taxes for which liability reserves had been established, and principal of and interest on debentures and short-term debt of the Pacific Company. The cost on the books of the Pacific Company of the assets transferred, less the amount of liabilities assumed, was $576,936,477.

In accordance with the plan Pacific Northwest Bell issued to the Pacific Company, in consideration for the transfer, 30,450,000 shares of its Common Stock and its 4½% demand note in the principal amount of $200,000,000.

The resulting capitalization of Pacific Northwest Bell as of July 1, 1961 (which includes the $110,000 par value of stock issued in March) was as follows:

Common Stock—par value $11 per share	$335,060,000
4½% Demand Note	200,000,000
Retained Earnings	41,986,477
	$577,046,477

The plan provided that within about three years after the transfer of assets, and at times related to its need for new capital, the Pacific Company would offer for sale to its shareholders all of the Common Stock of Pacific Northwest Bell issued to it. The plan described the procedures to be followed in connection with such offerings. The price for each offering would be determined at the time of the offering. The American Company would receive no rights to purchase Common Stock with respect to its holdings of preferred shares of the Pacific Company. The other holders of preferred shares of the Pacific Company would receive rights to purchase Common Stock which rights would come from rights which the American Company would otherwise have received with respect to its holdings of common shares of the Pacific Company. It was stated in the plan that the American Company expected to exercise its rights to purchase the Common Stock offered to it under each of the offerings. Under the present offering, which is the initial offering under the plan, the American Company expects to purchase 15,548,140 shares of Common Stock, constituting approximately 51% of the Common Stock outstanding.

In accordance with the plan, it is intended that within about three years after the transfer of assets Pacific Northwest Bell will sell publicly several issues of debentures for the purpose of refunding the demand note issued to the Pacific Company. It is expected that the first of such debenture issues will be sold before the end of this year and will be in the principal amount of $50,000,000.

During the period of about three years within which the Pacific Company expects to dispose of the Common Stock issued to it, and within which Pacific Northwest Bell expects to refund the demand note issued to the Pacific Company, it is intended that Pacific Northwest Bell will finance its construction program by advances from the American Company, which advances are expected to be substantial.

As provided in the plan, Pacific Northwest Bell has entered into a License Contract with the American Company, a contract with the American Company covering the division of revenues from the interstate and foreign service furnished by the companies of the Bell System, and a Standard Supply Contract with Western Electric Company, Incorporated (see "Certain Contracts"). It has also entered into a Plan for Employees' Pensions, Disability Benefits and Death Benefits, and a related Pension Trust Agreement with Bankers Trust Company, Trustee, in the same form as the Pension Plan and related Pension Trust Agreement of the Pacific Company. The Pension Plan and Pension Trust Agreement continue the same benefits for the employees of Pacific Northwest Bell as they had before. There has been transferred to the

Pension Fund of Pacific Northwest Bell from the Pension Fund of the Pacific Company the portion of the Pension Fund of the Pacific Company, actuarially determined, applicable to employees employed in Washington, Oregon and Idaho at the time of the transfer of the business and to persons who at the time of their retirement were employees of the Pacific Company in these States.

* * * * *

EXHIBIT 34-HH

(Presentation by J. O. Einerman 8/25/61)

PRESENTATION TO DIRECTORS—AUGUST 25

There are two basic decisions to be made in connection with the first offering of Pacific Northwest Bell shares; first, what price should be set for the shares, and second, if the price decided upon is in excess of the $11 par value of the shares, should a change be made in our company's dividend to compensate the shareholders for the additional capital invested in our company.

You will recall that the Plan for Reorganization approved at the 1961 Annual Meeting contemplates a first offering of about 56% of the stock of the new company. This equates to an offer on the basis of one Pacific Northwest Bell share for each six common shares of Pacific and seven new shares for each six preferred shares of Pacific. As you know, each of our preferred shares has seven times the rights of each common share because the preferred shares were not split and still have a $100 par value as compared with the $14-2/7 par value of the common shares. In accordance with the Plan, the American Company will receive no rights on its preferred shares and it is giving up enough of its common share rights so that the offer can be made to the preferred shareholders other than American. On this basis, the total number of Pacific Northwest Bell shares in the first offering will be 17,459,490 having a total par value of about $192 million. We shall then have about 13,000,000 shares remaining for a subsequent offer or offerings.

First, let us look at the schedule we propose to follow. (Turn to Chart 1 and run through schedule. Make these points:

1. Northwest Board authorized payment of 22¢ dividend for the third quarter and indicated their intention to declare a 22¢ dividend in the fourth quarter.
2. Northwest has agreed to list their shares on the American Stock Exchange and on the Pacific Coast Stock Exchange.)

Now let us look at the important factors to be considered in setting the selling price for the first offering of Pacific Northwest Bell shares. (Turn to Chart 2) I shall just run through these items because we shall develop each one separately. (Mention each item shown on chart.)

Now as to the tax status of the rights to be issued to our shareholders. (Turn to Chart 3 and explain. Mention that we are still working to improve the ruling. Make the point that some may claim there is discrimination between the treatment of the individual shareholders and the corporate shareholders (including American) and that this discrimination becomes less important with a higher offering price and resulting lower rights values.)

Next, let us consider the market value which may be placed on the shares we are selling. (Turn to Chart 4) Market value is an important factor of course since, if there were no other factors in the picture, it would be desirable to sell an asset of the company at or near its fair market value. (Then explain Chart 4).

The next chart (Turn to Chart 5) shows the rights values which have been received by Pacific's shareholders

in the post-war period and also shows the rights values involved in the most recent Bell System issues. Since many of our shareholders consider rights values to be in the nature of additional dividends and particularly since the tax ruling we have contemplates that these particular rights values will be treated as taxable income to the individual shareholders, it appears that the price set should contemplate reasonable rights values.

The next chart (Turn to Chart 6) shows the rights values which might be expected at various offering prices. The values are computed on the basis of a market price of the new shares at two times par value and at two and one-half times par value. Here I am not saying that the price of the new shares will run between $22 and $27.50 because frankly I don't know how the stock market will react to the new shares. The price may run higher than this range. But what I am saying is that sitting here today I believe it is fair and reasonable, with all of the uncertainties that exist, to set the offering price having in mind that a conservative valuation of the new shares will run between two and two and one-half times par.

Of course, when a subsequent offering is made, we shall have the benefit of the pricing of the shares in the stock markets and the price set then may be higher or lower than that set for the first offering.

The next chart (Turn to Chart 7) shows the requirements of our company for new capital during the balance of 1961 and 1962. You will see that we'll be well able to use whatever proceeds we have from this offering.

(Turn to Chart 8) This chart shows the proceeds we shall receive at various offering prices. Each dollar

difference on the first offering means about $17.5 million and each dollar difference on the total offerings means about $30.5 million. The second column is very important. This shows the amounts we would receive in excess of the par value of the shares sold. You will recall that in the past we have always issued our own shares at par and we have argued that shareholders should be given a return on any dollars they are asked to invest in excess of par. Consistent with that position, if the offering price is set above par, we believe that we should consider increasing the dividend to pay the shareholders a return on the additional dollars they invest as shown in this column. I should mention here that any amount received by the company in excess of par value will be reflected in the capital surplus account and not in earned surplus, under rulings of the Federal Communications Commission.

There is one more important factor to be considered. (Turn to Chart 9) This chart shows the total of Federal and state taxes we shall have to pay in connection with the reorganization. You will note that the higher the offering price, the more taxes we shall have to pay. The first column represents what we expect to pay. The second column shows what the taxing authorities may try to collect, but we believe that we can resist such demands.

As we have gone through these factors, you have probably noted that some of them seem to argue for a high offering price and some of them argue for a low offering price. Where we come out is somewhere in between. (Turn to Chart 10). The figure we recommend is $16 per share. This appears to give a good rights value, not too high and not too low. The taxes to be paid by the company

are kept at a reasonable figure. The proceeds fit the company's need for new capital. Actually we would have about $34 million of cash after repaying all of the outstanding notes, but we would use this in about two months. Also there is a dividend pattern which will tie in very nicely with the proceeds received in excess of par value. Let me place the next chart alongside of this one to show this. (Place Chart 11 alongside of Chart 10). You will note that our present dividend of 28½ cents per quarter ($1.14 per year) is a return of 7.98% on the shareholders' investment. If the new shares are sold at $16, the additional investment in the company will be about $87.3 million. By changing the dividend to 30 cents per quarter ($1.20 per year) we would be paying a return of 7.94% which is as close as we can come to the current rate.

An increase in dividend will mean of course a slightly higher payout ratio (83%) than we have had in the last year and one-half (80%), but we do not think that this is disturbing in view of the increase in our surplus position as a result of the additional investment of $87.3 million, which increase will give the company a higher earnings potential in the future.

To summarize, it is our recommendation that a selling price of $16 per share be set for the first offering of Pacific Northwest Bell shares and that the Directors indicate their intention to pay a dividend of 30 cents per common share starting with the dividend to be paid in December 1961.

TENTATIVE SCHEDULE (1)

SALE OF PACIFIC NORTHWEST BELL STOCK

Northwest Directors Authorize Filing Registration Statement with S.E.C. and Set Dividend on New Stock	Aug. 24—Thurs.
Pacific Directors Authorize Sale of Stock and Set Selling Price	Aug. 25—Fri.
File Registration Statement with S.E.C.	Aug. 25—Fri.
Effective Date of Registration Statement	Sept. 13—Wed.
Start When-Issued Trading in Stock and Rights	Sept. 14—Thurs.
Ex Rights Date	Sept. 15—Fri.
Record Date for Rights	Sept. 20—Wed.
Mail Prospectus and Warrants	Sept. 29—Fri.
Expiration of Purchase Period	Oct. 20—Fri.

FACTORS TO BE CONSIDERED (2)

1. Tax Status of Rights To Be Issued.
2. Market Value of Shares To Be Sold.
3. Rights Values Received in Past.
4. Rights Values at Various Offering Prices.
5. Company's Requirements for New Capital.
6. Proceeds at Various Offering Prices and Shareholders' Investment Above Par.
7. Taxes To Be Paid at Various Offering Prices.

TAX STATUS OF RIGHTS TO BE ISSUED (3)

Corporate Shareholders

If Exercised—No immediate tax consequence if offering price exceeds Pacific's tax basis ($11.35 per share).

If Sold—Proceeds taxable as ordinary income.

Other Shareholders

If Exercised—Value of rights taxable as dividend income.

If Sold—Proceeds taxable as ordinary income.

MARKET VALUE OF SHARES TO BE SOLD (4)

1. Bell System Issues in 1961
   (American, Pacific, New England, Mountain States, Southern New England, and Cincinnati and Suburban)
      Market prices—average low of 2 times par to average high of 3 times par.
      Dividend yield—average low of 3.2% to average high of 4.2%.

   New shares—$22 to $33 if measured in relation to par of $11.
   —$21 to $27 if measured in relation to dividend of 88¢.
2. Shares offered will be those of new company.
3. Shares will have no rights values for at least three years.
4. Individual shareholders may sell rights because of tax status.

Reasonable assumption that shares will sell in range of 2 to 2½ times par.

RIGHTS VALUES RECEIVED IN PAST (5)

Pacific Company			High	Low	Average
1 for 10	1947	Common and Preferred	$2.63	$2.00	$2.38
6	1948	" " "	.50	.02	.17
5	1949	" " "	.09	.02	.03
6	1950	" " "	1.81	.63	1.23
9	1951	" " "	1.13	.75	.92
9	1952	" " "	2.13	1.56	1.83
7	1954	" " "	4.94	4.06	4.36
6	1955	" " "	6.63	5.69	5.98
6	1956	" " "	5.38	3.88	4.55
6	1957	" " "	3.63	2.75	3.03
8	1958	" " "	6.31	4.81	5.29
10	1960	Common	1.56	1.19	1.38
7 for 10		Preferred	10.94	8.31	9.63
Recent Bell System Issues					
1 for 20	1961	American Company	2.28	1.19	1.62
1 for 7	1961	New England Company	2.63	1.31	1.82
1 for 5	1960	Mountain States Company	2.56	1.94	2.28

8/14/61

RIGHTS VALUES AT VARIOUS OFFERING PRICES (6)

	Market Price	
Offering Price	Two Times Par	Two and One-Half Times Par
$11 (par)	$1.83	$2.75
12.50 (book)	1.58	2.50
14	1.33	2.25
16	1.00	1.92
18	.67	1.58
20	.33	1.25
25	—	.42

COMPANY'S REQUIREMENTS FOR NEW CAPITAL (7)

1961	
June 30	$233,000,000
Sept. 30	245,500,000
Dec. 31	301,900,000
1962	
Mar. 31	344,900,000
June 30	400,400,000
Sept. 30	413,100,000
Dec. 31	472,100,000

PROCEEDS AT VARIOUS OFFERING PRICES AND SHAREHOLDERS' INVESTMENT ABOVE PAR (8)

Offering Price	Proceeds	Shareholders' Investment Above Par
First Offering (17,459,490 shares)		
$11 (par)	$192,054,000	—
12.50 (book)	218,244,000	$ 26,189,000
14	244,433,000	52,378,000
16	279,352,000	87,297,000
18	314,271,000	122,216,000
20	349,190,000	157,135,000
25	436,487,000	244,433,000
Total Offerings (30,460,000 shares)		
$11 (par)	$335,060,000	—
12.50 (book)	380,750,000	$ 45,690,000
14	426,440,000	91,380,000
16	487,360,000	152,300,000
18	548,280,000	213,220,000
20	609,200,000	274,140,000
25	761,500,000	426,440,000

TAXES TO BE PAID AT VARIOUS OFFERING PRICES (9)

Offering Price	Probable Minimum	Possible Maximum
First Offering (17,459,490 shares)		
$11 (par)	$1,001,000	$ 5,970,000
12.50 (book)	1,547,000	6,516,000
14	2,264,000	7,233,000
16	3,219,000	8,188,000
18	4,175,000	9,180,000
20	5,131,000	11,057,000
25	7,540,000	15,770,000
Total Offerings (30,460,000 shares)		
$11 (par)	$1,115,000	$ 6,084,000
12.50 (book)	2,067,000	7,036,000
14	3,318,000	8,287,000
16	4,985,000	9,954,000
18	6,652,000	11,682,000
20	8,320,000	14,959,000
25	12,524,000	23,182,000

FIRST OFFERING (10)

Basis of Offer................1 for 6 Common
7 for 6 Preferred

Offering Price....................$16 per share

Probable Rights Value...........$1.00 to $2.00

Gross Proceeds $279,352,000

Proceeds in Excess
of Par Value.........................$87,297,000

Taxes............................$ 3,219,000

PACIFIC'S COMMON SHARES (11)

Before First Offering

Investment	$1,496,528,000
Common Shares	104,756,943
Average Per Share	$14.29

Dividend of
$1.14 is 7.98% of $14.29

After First Offering

Investment—Old	$1,496,528,000
—New	87,297,000
—Total	$1,583,825,000
Common Shares	104,756,943
Average Per Share	$15.12

Dividend of
$1.20 is 7.94% of $15.12

EXHIBIT 48-VV

Daily Prices on American Stock Exchange of Common Stock of Northwest from September 14, 1961 through October 20, 1961

1961 Date		High	Low	Average
September	14	31⅜	28¼	29.8125
	15	28⅛	26¾	27.4375
	18	28⅜	27¾	28.0625
	19	28	27¾	27.8750
	20	27½	26⅞	27.1875
	21	27½	27	27.2500
	22	27	26¾	26.8750
	25	27	26¾	26.8750
	26	26¾	26⅛	26.4375
	27	26¾	26⅜	26.5625
	28	27	26⅝	26.8125
	29	26⅞	26¾	26.8125
October	2	26¾	25⅞	26.3125
	3	25⅞	25⅝	25.7500
	4	25½	25¼	25.3750
	5	26⅜	25⅝	26.0000
	6	26¾	26⅛	26.4375
	9	27½	26⅞	27.1875
	10	26⅞	26¾	26.8125
	11	27	26⅞	26.9375
	12	27¼	26⅞	27.0625
	13	28⅛	27⅜	27.7500
	16	28⅛	27⅝	27.8750
	17	27⅝	27¼	27.4375
	18	27⅜	27¼	27.3125
	19	27⅜	27⅛	27.2500
	20	28¼	27⅜	27.8125

EXHIBIT 49-WW

Daily Prices on American Stock Exchange of Rights Issued by Pacific in 1961 to Purchase Northwest Stock

1961 Date		High	Low	Average
*September	14	2.50	1.96875	2.234375
	15	2.03125	1.8125	1.921875
	18	2.09375	1.9375	2.015625
	19	2.00	1.90625	1.953125
	20	1.90625	1.8125	1.859375
	21	1.96875	1.8125	1.890625
	22	1.84375	1.75	1.796875
	25	1.84375	1.75	1.796875
	26	1.8125	1.65625	1.734375
	27	1.78125	1.71875	1.75
	28	1.8125	1.75	1.78125
	29	1.84375	1.6875	1.765625
October	2	1.8125	1.5625	1.6875
	3	1.65625	1.59375	1.625
	4	1.59375	1.53125	1.5625
	5	1.71875	1.59375	1.65625
	6	1.78125	1.6875	1.734375
	9	1.90625	1.75	1.828125
	10	1.8125	1.78125	1.796875
	11	1.8125	1.78125	1.796875
	12	1.875	1.8125	1.84375
	13	2.00	1.875	1.9375
	16	2.03125	1.9375	1.984375
	17	1.9375	1.84375	1.890625
	18	1.875	1.84375	1.859375
	19	1.875	1.8125	1.84375
	20	2.03125	1.875	1.953125

*When issued basis, September 14 through September 29, 1961.

EXHIBIT 54-BBB

Data Regarding Response of Minority Shareholders of Pacific to 1961 and 1963 Offerings of Northwest Stock

Class of Shareholder	Number and Percent of Minority Shareholders of Record Exercising Rights to Purchase Northwest Stock				Number of Shares Purchased by Minority Shareholders of Record, and Percent of Total Shares Offered To Minority Shareholders of Record Which Was Purchased by Them			
	Number		Percent		Number		Percent	
	1961	1963	1961	1963	1961	1963	1961	1963
Individuals	24,440	23,272	65.8	56.1	905,029	540,148	62.6	52.5
Trustees	327	339	43.1	43.5	21,560	15,875	50.5	44.3
Brokers	177	163	87.6	78.4	613,789	650,028	431.0	631.1
Nominees	145	124	52.7	40.1	49,295	29,759	30.9	22.7
Others	333	347	53.6	50.6	102,500	85,696	84.9	64.2
Total	25,422	24,245	65.2	55.8	1,692,173	1,321,506	88.53	92.19

	1961		1963	
	Number	Percent	Number	Percent
Minority shareholders of record who allowed their rights to lapse	1,088	2.8	2,219	5.1
Rights issued to minority shareholders which were permitted to lapse	80,759	0.7	135,689	1.2

Exhibit 56 DDD
Sheet 1 of 2

SELECTED STATISTICS OF OPERATIONS AND ASSETS, FOR THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY AND PACIFIC NORTHWEST BELL TELEPHONE COMPANY - COVERING 1950 THROUGH A PORTION OF 1964

	Number of Telephones End of Period	Number of Central Offices End of Period	Number of Customers End of Period	Total Telephone Plant End of Period (Rounded 000's)	Telephone Plant Less Depr. Reserve End of Period (Rounded 000's)	Number of Employees End of Period	Salary And Wage Payments During Period (Rounded 000's)	Operating Revenues During Period (Rounded 000's)	Total Toll Calls Completed During Period (Rounded 000's)	Total Originating Local Calls During Period (In 000's)	Total Assets End of Period (Rounded 000's)	Total Assets Less Invest. in and Advances to Pac. NW Bell Tel. Co. End of Period (Rounded 000's)	Capital Stock Equity End of Period (Rounded 000's)
The Pacific Telephone and Telegraph Company													
Year 1950	4,209,876	941	3,168,460	$1,319,040	$1,001,976	68,216	$232,677	$ 425,883	NA	NA	$1,109,109	$1,109,109	584,166
1951	4,453,624	983	3,341,341	1,432,450	1,087,232	72,623	257,897	471,898	196,981	7,398,883	1,206,863	1,206,863	652,282
1952	4,701,259	996	3,512,304	1,568,181	1,193,717	75,921	290,412	529,038	171,429	7,730,547	1,320,382	1,320,382	728,353
1953	4,987,108	1,017	3,703,711	1,723,243	1,323,645	77,343	315,853	571,579	176,336	8,060,394	1,456,057	1,456,057	734,913
1954	5,282,666	1,039	3,886,611	1,866,017	1,442,672	76,540	330,766	623,962	181,937	8,513,239	1,581,982	1,581,982	847,039
1955	5,715,671	1,059	4,100,231	2,061,219	1,609,433	85,093	366,161	706,358	193,921	9,311,210	1,782,301	1,782,301	1,002,000
1956	6,225,402	1,097	4,340,496	2,352,821	1,881,428	89,909	407,738	781,418	213,857	9,947,760	2,085,046	2,085,046	1,180,902
1957	6,607,994	1,152	4,516,316	2,683,057	2,193,690	91,576	440,932	852,209	228,404	10,961,175	2,395,035	2,395,035	1,378,899
1958	6,941,872	1,186	4,666,726	2,913,191	2,388,568	82,580	434,385	924,303	243,960	11,045,022	2,594,395	2,594,395	1,560,962
1959	7,442,202	1,211	4,899,456	3,144,145	2,575,494	80,334	440,924	1,026,546	275,028	11,671,878	2,806,294	2,806,294	1,598,594
1960	7,866,619	1,242	5,054,781	3,401,753	2,792,196	82,619	471,670	1,119,748	300,956	12,181,103	3,046,901	3,046,901	1,770,582
First Six Months 1961ϕ	8,047,489	1,249	5,134,742	3,531,636	2,900,499*	82,872	237,131	585,726	154,903	6,186,771	3,149,307*	3,149,197*	1,785,571
July 1,1961	6,470,546	912	4,058,904	2,826,932	2,334,884*	67,111	XX	XX	XX	XX	3,121,783	2,545,620	1,785,571
Year 1961	6,695,683	927	4,170,776	2,933,082	2,420,910	65,344	438,703	1,081,934	290,566	11,302,630	2,990,442	2,679,710	1,858,789
1962	7,117,647	956	4,360,886	3,177,429	2,638,250	67,871	425,784	1,055,167	289,132	10,780,346	3,149,859	2,889,670	1,880,600
1963	7,479,848	1,000	4,521,507	3,467,498	2,890,748	71,843	458,938	1,146,352	319,273	11,274,073	3,166,663	3,166,663	1,951,861
First Five Months 1964	7,689,408	1,065	4,612,126	3,610,683	3,013,336	74,521	201,633	501,275	141,115	4,930,389	3,309,610	3,309,610	1,951,039
Pacific Northwest Bell Telephone Company													
July 1,1961	1,576,963	337	1,075,838	$ 704,704	$ 565,623**	15,761	$ XX	$ XX	XX	XX	$ 603,679**#		376,629
Last Six Months 1961	1,628,067	338	1,098,477	728,096	583,831	15,421	47,497	119,546	31,063	1,254,170	630,708		378,283
Year 1962	1,699,911	343	1,123,619	774,959	624,914	14,997	97,714	248,718	65,395	2,665,209	674,647		384,093
1963	1,751,332	349	1,144,634	813,465	656,397	14,760	96,826	259,440	67,940	2,677,874	710,004		423,911
First Five Months 1964	1,773,910	355	1,153,286	828,383	666,563	14,984	40,055	111,835	28,669	1,147,010	718,043		427,846

NA = Not Available
* Restated to reflect effect of retroactive prescription of revised depreciation rates considered applicable to the first six months of 1961.
\# Includes Organization Expense of $8,000 rounded.
ϕ Prior to separation.

NOTE: See Exhibit 56 DDD (1) attached for comparative balance sheets of The Pacific Telephone and Telegraph Company as of June 30, 1961, July 1, 1961, and December 31, 1961.

Exhibit 56 DDD
Sheet 2 of 2

SELECTED STATISTICS OF OPERATIONS AND ASSETS, DIVIDED BETWEEN CALIFORNIA AND PACIFIC NORTH-WEST - COVERING 1950 THROUGH A PORTION OF 1964

	Number of Telephones End of Period	Number of Central Offices End of Period	Number of Customers End of Period	Total Telephone Plant End of Period (Rounded 000's)	Telephone Plant Less Depr. Reserve End of Period (Rounded 000's)	Number of Employees End of Period	Salary And Wage Payments During Period (Rounded 000's)	Operating Revenues During Period (Rounded 000's)	Total Toll Calls Completed During Period (Rounded 000's)	Total Originating Local Calls During Period (In 000's)	Total Assets End of Period (Rounded 000's)	Total Assets Less Invest. In and Advances to Pac. NW Bell Tel. Co. End of Period (Rounded 000's)
Pacific Telephone - State of California												
Year 1950	3,233,648	650	2,394,974	$1,013,888	$ 772,747	52,872	$180,042	$ 327,100	NA	NA	(These data not available by states prior to separation)	
1951	3,428,902	679	2,534,314	1,101,160	838,117	57,044	201,331	362,807	152,949	5,598,086		
1952	3,635,435	691	2,674,845	1,209,456	923,727	60,135	228,706	409,611	127,246	5,877,417		
1953	3,879,197	708	2,836,870	1,338,003	1,033,386	61,611	249,992	443,532	130,677	6,171,135		
1954	4,127,396	733	2,990,317	1,451,391	1,128,521	61,087	262,903	484,533	135,893	6,568,911		
1955	4,479,890	756	3,162,271	1,610,027	1,264,987	67,944	291,245	550,871	146,710	7,264,635		
1956	4,914,673	788	3,368,960	1,844,242	1,484,549	71,926	325,818	613,537	164,428	7,785,922		
1957	5,244,578	836	3,520,741	2,116,273	1,736,568	73,804	353,619	671,786	178,412	8,679,577		
1958	5,527,697	860	3,646,559	2,303,011	1,894,881	66,905	349,006	735,259	193,016	8,734,876		
1959	5,960,618	879	3,851,541	2,496,194	2,051,978	65,025	356,588	820,791	220,319	9,276,510		
1960	6,321,785	906	3,989,102	2,716,729	2,241,879	67,045	382,718	898,558	243,547	9,763,387		
First Six Months 1961	6,470,546	912	4,058,904	2,826,932	2,334,884*	67,111	191,595	470,988	126,294	4,958,617		
Year 1961	6,695,663	927	4,170,776	2,933,082	2,420,910	65,344	393,167	967,196	261,958	10,074,476	2,990,442	2,679,710
1962	7,117,647	956	4,360,886	3,177,429	2,638,250	67,871	425,784	1,055,167	289,132	10,780,346	3,149,859	2,889,670
1963	7,479,848	1,000	4,521,507	3,467,498	2,890,748	71,843	458,938	1,146,352	319,273	11,274,073	3,166,663	3,166,663
First Five Months 1964	7,689,408	1,065	4,612,126	3,610,683	3,013,336	74,521	201,633	501,275	141,115	4,930,389	3,309,610	3,309,610
Pacific Telephone - Northwest Division												
Year 1950	976,228	291	773,486	$ 305,152	$ 229,229	15,344	$ 52,635	$ 98,783	NA	NA		
1951	1,024,722	304	807,027	331,290	249,115	15,579	56,566	109,091	44,032	1,800,797		
1952	1,065,824	305	837,459	358,725	269,990	15,786	61,706	119,427	44,183	1,853,130		
1953	1,107,911	309	866,841	385,240	290,259	15,732	65,861	128,047	45,659	1,889,259		
1954	1,155,270	306	896,294	414,626	314,151	15,453	67,863	139,429	46,044	1,944,328		
1955	1,235,781	303	937,980	451,192	344,446	17,149	74,916	155,487	47,211	2,046,575		
1956	1,310,729	309	971,536	508,579	396,879	17,983	81,920	167,881	49,429	2,161,838		
1957	1,363,416	316	995,973	566,784	457,122	17,772	87,313	180,423	49,992	2,281,598		
1958	1,414,175	326	1,020,167	610,180	493,687	15,675	85,379	189,044	50,964	2,310,146		
1959	1,481,584	332	1,047,915	647,951	523,516	15,309	84,336	205,755	54,709	2,395,368		
1960	1,544,834	336	1,065,679	685,024	550,317	15,574	88,952	221,190	57,409	2,417,716		
First Six Months 1961	1,576,943	337	1,075,838	704,704	565,615*	15,761	45,536	114,738	28,609	1,228,154		

NA = Not Available
*Restated to reflect effect of retroactive prescription of revised depreciation rates considered applicable to the first six months of 1961.

NOTE: Estimated square miles of territory served as of June 30, 1961: State of California 46,670; Northwest Division 40,903.

EXHIBIT 56 DDD(1)

**COMPARATIVE BALANCE SHEETS OF
THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY
AS OF JUNE 30, 1961, JULY 1, 1961 AND DECEMBER 31, 1961
(ROUNDED 000's)**

	1961		
ASSETS	**June 30***	**July 1***	**December 31**
Total Telephone Plant	$3,531,636	$2,826,932	$2,933,082
Less: Depreciation Reserve	627,664	489,458	512,172
Total Telephone Plant less Reserve	2,903,972	2,337,474	2,420,910
Investments In, and Advances to Affiliated Cos.	45,810	622,746	357,732
Other Investments	963	677	751
Cash and Temporary Cash Investments	14,065	13,602	34,565
Material and Supplies	11,494	9,591	8,750
Other Current Assets	140,017	111,446	127,057
Prepaid Accounts and Deferred Charges	36,459	29,720	40,677
Total Assets	$3,152,780	$3,125,256	$2,990,442
LIABILITIES AND CAPITAL			
Total Capital Stock	$1,578,528	$1,578,528	$1,578,528
Capital Surplus	—	41,986	101,326
Earned Surplus	207,043	165,057	178,935
Total Capital Stock and Surplus	1,785,571	1,785,571	1,858,789
Funded Debt	902,000	902,000	902,000
Advances from A.T.& T. Co.	233,000	233,000	—
Total Capitalization	2,920,571	2,920,571	2,760,789
Current Liabilities	120,873	100,222	112,773
Accrued Liabilities	101,185	94,865	108,913
Deferred Credits	10,151	9,598	7,967
Total Liabilities and Capital	$3,152,780	$3,125,256	$2,990,442

Decrease from June 30 to July 1 $27,524

Reflects assumption of liabilities by Pacific Northwest Bell offset in Investments In Affiliated Cos.

Decrease from July 1 to December 31 $134,815

Reduction of Advances from A.T.& T. Co. to zero after sale of Pacific Northwest Bell shares plus normal corporate changes.

*Excludes effect of retroactive depreciation adjustment for the first six months of 1961, amounting to $2,590 for the State of California and $883 for the Northwest Division or $3,473 for Pacific Company.

EXHIBIT 67-OOO

Letterhead of
U. S. TREASURY DEPARTMENT
Internal Revenue Service
Washington 25, D. C.

In Reply Refer to
June 28, 1961 T:R:C-HNB

The Pacific Telephone and Telegraph Company
140 New Montgomery Street
San Francisco 5, California

Gentlemen:

This is in reply to Mr. Harry R. Horrow's letter of February 7, 1961, and subsequent correspondence, in which several rulings are requested with respect to the transfer of your business and properties in certain states to a new corporation.

The facts are stated to be:

The Pacific Telephone and Telegraph Company ("Pacific Company") is a subsidiary of the American Telephone and Telegraph Company ("American Company") which owns 90.25 percent of its common stock and 78.17 percent of its preferred stock, representing 89.62 percent of total voting power. The affiliated group of which the American Company is the common parent file consolidated income tax returns on the calendar year basis. All unrealized intercompany profits and loss arising from transactions between members of the affiliated group, which effect [sic] consolidated taxable income, have been eliminated in the consolidated returns filed by the affiliated group for the years 1954 to date.

The Pacific Company, a California corporation, furnishes telephone communication services in States of California, Oregon, Washington and Northern Idaho. Its wholly-owned subsidiary, Bell Telephone Company of Nevada, furnishes similar services in the State of Nevada. The Pacific Company and its subsidiary are subject to regulation in the States in which they operate by regulatory authorities which have power within their respective jurisdictions with respect to intrastate rates and services and other matters. Both corporations are also subject to regulation by the Federal Communications Commission with respect to interstate rates, lines and services, valuations and other matters.

Under the proposed Plan for Reorganization ("Plan"), which was approved by the directors of the Pacific Company on January 27, 1961 and approved and adopted by the shareholders at their annual meeting on March 24, 1961, the present business and properties of the Pacific Company will be divided so that the Pacific Company will confine its operations to the State of California and the new corporation will conduct the business formerly carried on by the Pacific Company in the States of Oregon, Washington and Idaho.

Pursuant to the Plan, the new corporation, Pacific Northwest Bell Telephone Company ("Northwest Company") was organized on March 27, 1961, under the laws of the State of Washington and 10,000 shares of its $11.00 par value capital stock were issued to the Pacific Company for $110,000 cash. Upon obtaining the necessary consents, approvals, and rulings, the Northwest Company will acquire the business and properties of the Pacific Company in the

States of Oregon, Washington and Idaho in consideration for (1) the assumption by the Northwest Company of operating liabilities, with certain exceptions, relating to the business of the Pacific Company in such States, and (2) the issuance to the Pacific Company by the Northwest Company of its capital stock and debt obligations in a total amount which will bear substantially the same relationship to the net book cost of the assets transferred and liabilities assumed as the total of the par value of the stock (common and preferred) and the aggregate principal amount of the debt obligations of the Pacific Company bears to the net book cost of all its assets less liabilities prior to the transfer of assets. The par value of capital stock, debt obligations and surplus of the Northwest Company will be in substantially the same proportions as the par value of stock (common and preferred), debt obligations and surplus of the Pacific Company prior to said transfer.

If the transfer were to be made as of June 30, 1961, it is estimated that assets and liabilities carried on the books of the Pacific Company at a net book cost of approximately $577,000,000 would be transferred to the Northwest Company and that the capitalization of the Northwest Company after the transfer would be approximately as follows:

Capital Stock	$335,000,000
Debt Obligations	200,000,000
Surplus	42,000,000
	$577,000,000

The Northwest Company will not assume any liabilities with respect to principal of and interest on the debentures and short-term debt of the Pacific Company. The basis to the Pacific Company of the properties transferred to the Northwest Company will exceed the liabilities of the Pacific Company assumed by the Northwest Company. The debt obligations issued by the Northwest Company to the Pacific Company will be promissory notes of the Northwest Company payable on demand and will be outstanding no more than three years.

Under the Plan, the Pacific Company will offer to its shareholders the right to purchase all the shares of capital stock of the Northwest Company acquired pursuant to such Plan. Eighty percent or more of the capital stock of the Northwest Company will be owned by the Pacific Company and/or the American Company at all times under the proposed Plan.

During the period of about three years required by the Pacific Company to dispose of the capital stock of the Northwest Company and by the Northwest Company to refund the debt obligations issued at the time of the transfer, it is intended that the Northwest Company will finance its construction program by advances from the American Company.

If the transfer of the Pacific Company's business and properties in the States of Oregon, Washington and Idaho is carried out in accordance with the Plan described above, it is concluded that:

(1) The above-described consummated transfer of cash by the Pacific Company to the Northwest Com-

pany in exchange for its stock and the proposed transfer of assets, subject to operating liabilities, by the Pacific Company to the Northwest Company in exchange for additional stock and demand notes will be treated, for Federal income tax purposes, as one integrated transaction.

The Northwest Company will be a member of the affiliated group of which the American Company is the common parent corporation.

(2) The above-described transfer of cash and other assets, subject to operating liabilities, by the Pacific Company to the Northwest Company in exchange for all of its outstanding stock and demand notes will constitute a transfer of property within the meaning of section 351 of the Internal Revenue Code. Gain or loss will be realized by the Pacific Company measured by the difference between the fair market value of the stock and the demand notes received plus the amount of liabilities assumed by the Northwest Company and the basis of the property transferred in exchange therefor. Under section 351(b) of the Code the gain, if any, will be recognized, but in an amount not in excess of the fair market value of the demand notes received. The loss, if any, will not be recognized.

However, if a consolidated return is filed for the taxable year in which the transaction occurs, any gain will be eliminated as an intercompany transaction under the provisions of section 1.1502-31 (b)(1) of the Income Tax Regulations.

(3) Under section 362 of the Code, the basis in the hands of the Northwest Company of the assets acquired in the transfer will be the same as it would be in the hands of the Pacific Company, increased in the amount of the gain recognized to the Pacific Company under section 351(b).

However, if the transfer occurs during a consolidated return period, the basis of the assets transferred to the Northwest Company will be the same as the basis of such assets in the hands of the Pacific Company under section 1.1502-38(b) of the regulations, since the gain under section 351(b) of the Code will be eliminated under section 1.1502-31 (b)(1) of the regulations.

(4) Under section 358 of the Code, the basis in the hands of the Pacific Company of the stock of the Northwest Company received in the transaction will be the same as the basis of the property exchanged, decreased by the fair market value of the demand notes received and increased by the amount of gain recognized to the Pacific Company under section 351(b) of the Code. This basis, as so determined, will be allocated equally among all of the shares of stock of the Northwest Company held by the Pacific Company immediately after the proposed exchange between the Pacific Company and the Northwest Company. The basis of the demand notes received will be their fair market value.

However, if the exchange occurs during a consolidated return period, the aggregate basis to the

Pacific Company of both the stock and demand notes received in the exchange will be the same as the basis of the property exchanged, decreased by the liabilities assumed.

(5) In determining the periods for which the Pacific Company has held the stock and demand notes received from the Northwest Company in the exchange, there shall be included the periods for which the Pacific Company held the assets transferred to the Northwest Company under section 1223(1) of the Code.

(6) The receipt by the shareholders of the Pacific Company of rights to purchase shares of stock of the Northwest Company will not result in taxable income to the shareholders.

(7) No taxable income will result to the shareholders of the Pacific Company by reason of holding the above-described rights to purchase shares of stock of the Northwest Company until the date of expiration of the rights, without having exercised, sold or exchanged them.

(8) The full amount realized by the shareholders of the Pacific Company upon the sale or exchange of the above-described rights to purchase shares of stock of the Northwest Company will constitute ordinary income to the shareholder so selling or exchanging the rights.

(9) The receipt by the shareholders of the Pacific Company of stock of the Northwest Company upon the exercise of the above-described rights, in

case of each shareholder which is not a corporation, will result in a distribution of property under section 301 of the Code in an amount equal to the excess, if any, of the fair market value of the stock of the Northwest Company at the time of the exercise of the rights over the amount paid for the stock; and, in the case of each shareholder which is a corporation, will result in a distribution of property under section 301 in an amount equal to the excess, if any, of the basis of the stock of the Northwest Company in the hands of the Pacific Company at the time of the exercise of the rights over the amount paid for the stock, assuming the basis of such stock is less than its fair market value.

The amount of the distribution, as determined above, will constitute a dividend to the extent provided for in sections 301(c) and 316 of the Code.

Section 355 of the Code will not be applicable to the receipt by the shareholders of the Pacific Company of stock of the Northwest Company upon exercise of the above-described rights.

If a consolidated return is filed for the taxable year in which the American Company exercises its rights to purchase stock of the Northwest Company, the dividend distribution will constitute an intercompany transaction to be eliminated under the provisions of section 1.1502-31(b)(1) of the regulations.

(10) Under section 1.1502-33(a) of the regulations any gain or loss to the Pacific Company will be eliminated on the sale of stock of the Northwest Company to the American Company upon the exercise of the above described rights, if the sale occurs during a consolidated return period.

(11) If a consolidated return is filed for the taxable year in which the Northwest Company refunds the demand notes issued to the Pacific Company, any gain or loss resulting from the payment will constitute an intercompany transaction to be eliminated under sections 1.1502-31(b)(1) and 1.1502-33(a) of the regulations.

No opinion is expressed as to whether an allocation of earnings and profits will be made between the Pacific Company and the Northwest Company as a result of the transfer of property.

A determination as to the fair market value of the demand notes of the Northwest Company is specifically reserved until the Federal income tax return of the affiliated group has been filed for the year in which the notes are received and has been examined by the District Director having jurisdiction in the matter.

In accordance with the authorization contained in a power of attorney on file in this office, a copy of this letter is being furnished to Mr. Harry R. Horrow, 225 Bush Street, San Francisco 4, California.

Very truly yours,
E. H. Hatfield
Acting Director, Tax Rulings Division

EXHIBIT 68-PPP

Letterhead of
U. S. TREASURY DEPARTMENT
Internal Revenue Service
Washington 25, D.C.

November 15, 1962

In Reply Refer to
T:R:R-LT

The Pacific Telephone and Telegraph Company
140 New Montgomery Street
San Francisco 5, California

Gentlemen:

This is in reply to Mr. Harry R. Horrow's letters dated July 6 and 24 and August 9, 1961, requesting a separate ruling covering the Federal income tax effects to your minority shareholders of the transaction described in our ruling dated June 28, 1961.

The Pacific Telephone and Telegraph Company (Pacific Company) is a subsidiary of the American Telephone and Telegraph Company (American Company) which owns 90.25 percent of its common stock and 78.17 percent of its preferred stock, representing 89.62 percent of total voting power. The affiliated group of which the American Company is the common parent file consolidated income tax returns on the calendar year basis. All unrealized inter-company profits and loss arising from transactions between members of the affiliated group, which affect consolidated taxable income, have been eliminated in the

consolidated returns filed by the affiliated group for the years 1954 to date.

The Pacific Company, a California corporation, furnishes telephone communication services in California, and until June 30, 1961, furnished such services in Oregon, Washington and Northern Idaho. Its wholly-owned subsidiary, Bell Telephone Company of Nevada, furnishes similar services in the State of Nevada. The Pacific Company and its subsidiary are subject to regulation in the States in which they operate by regulatory authorities which have power within their respective jurisdictions with respect to intrastate rates and services and other matters. Both corporations are also subject to regulation by the Federal Communications Commission with respect to interstate rates, lines and services, valuations and other matters.

Under the proposed Plan for Reorganization ("Plan"), which was approved by the directors of the Pacific Company on January 27, 1961 and approved and adopted by the shareholders at their annual meeting on March 24, 1961, the business and properties of the Pacific Company were to be divided so that the Pacific Company would confine its operations to the State of California and the new corporation would conduct the business formerly carried on by the Pacific Company in the States of Oregon, Washington and Idaho.

Pursuant to the Plan, the new corporation, Pacific Northwest Bell Telephone Company (Northwest Company) was organized on March 27, 1961, under the laws of the State of Washington and 10,000 shares of its $11.00 par value

capital stock were issued to the Pacific Company for $110,000 cash. On June 30, 1961, the Northwest Company acquired the business and properties of the Pacific Company in Oregon, Washington and Idaho in consideration for (1) the assumption by the Northwest Company of operating liabilities, with certain exceptions, relating to the business of the Pacific Company in such States, and (2) the issuance to the Pacific Company by the Northwest Company of its capital stock and debt obligations in a total amount which bears substantially the same relationship to the net book cost of the assets transferred and liabilities assumed as the total of the par value of the stock (common and preferred) and the aggregate principal amount of the debt obligations of the Pacific Company bore to the net book cost of all its assets less liabilities prior to the transfer of assets. The par value of capital stock, debt obligations and surplus of the Northwest Company is in substantially the same proportions as the par value of stock (common and preferred), debt obligations and surplus of the Pacific Company prior to said transfer.

The Northwest Company did not assume any liabilities with respect to principal of and interest on the debentures and short-term debt of the Pacific Company. The basis to the Pacific Company of the properties transferred to the Northwest Company exceeded the liabilities of the Pacific Company assumed by the Northwest Company. The debt obligations issued by the Northwest Company to the Pacific Company are promissory notes of the Northwest Company payable on demand and will be outstanding no more than three years.

Under the Plan, the Pacific Company will offer to its shareholders the right to purchase all the shares of capital stock of the Northwest Company acquired pursuant to such Plan. Eighty percent or more of the capital stock of the Northwest Company will be owned by the Pacific Company and/or the American Company at all times under the proposed Plan.

During the period of about three years required by the Pacific Company to dispose of the capital stock of the Northwest Company and by the Northwest Company to refund the debt obligations issued at the time of the transfer, it is intended that the Northwest Company will finance its construction program by advances from the American Company.

Based solely on the information furnished, it is held as follows:

(1) The receipt by the shareholders of the Pacific Company of rights to purchase shares of stock of the Northwest Company will not result in taxable income to the shareholders.

(2) No taxable income will result to the shareholders of the Pacific Company by reason of holding the above-described rights to purchase shares of stock of the Northwest Company until the date of expiration of the rights, without having exercised, sold or exchanged them.

(3) The full amount realized by the shareholders of the Pacific Company upon the sale or exchange of the above-described rights to purchase shares of stock of the Northwest Company will constitute

ordinary income to the shareholder so selling or exchanging the rights.

(4) The receipt by the shareholders of the Pacific Company of stock of the Northwest Company upon the exercise of the above-described rights, in case of each shareholder which is not a corporation, will result in a distribution of property under section 301 of the Code in an amount equal to the excess, if any, of the fair market value of the stock of the Northwest Company at the time of the exercise of the rights over the amount paid for the stock; and, in the case of each shareholder which is a corporation, will result in a distribution of property under section 301 in an amount equal to the excess, if any, of the basis of the stock of the Northwest Company in the hands of the Pacific Company at the time of the exercise of the rights over the amount paid for the stock, assuming the basis of such stock is less than its fair market value.

The amount of the distribution, as determined above, will constitute a dividend to the extent provided for in sections 301(c) and 316 of the Code.

Neither section 346 nor section 355 of the Code will be applicable to the receipt by the shareholders of the Pacific Company of stock of the Northwest Company upon exercise of the above-described rights.

(5) The basis in the hands of the shareholders of the Pacific Company (other than the American Company) of the stock of the Northwest Company received upon the exercise of the rights will, in the case of each shareholder which is not a corporation, be the fair market value of the stock on the date of exercise, and will, in the case of each shareholder which is a corporation, be the basis of the stock of Northwest in the hands of Pacific on the date of exercise, assuming the basis of such stock is less than its fair market value and greater than the purchase price of the stock. The holding period of this stock will begin on the date on which the rights to acquire it are exercised.

In accordance with the authorization contained in a power of attorney on file in this office, a copy of this letter is being furnished to Mr. Harry R. Horrow, 225 Bush Street, San Francisco 4, California.

Very truly yours,
John W. S. Littleton
Director, Tax Rulings Division

OFFICIAL REPORT OF PROCEEDINGS
BEFORE
THE TAX COURT OF THE UNITED STATES

OSCAR E. BAAN and EVELYN K. BAAN, IRVING GORDON and MARGARET GORDON, Petitioner, vs. COMMISSIONER OF INTERNAL REVENUE, Respondent.	Docket No. 949-63 3949-63

HEARING AT Washington, D. C.

DATE 15 December 1964

[3] PROCEEDINGS

THE CLERK: Docket 949-63, Oscar E. Baan and Evelyn K. Baan, and Docket 3949-63, Irving Gordon and Margaret Gordon.

MR. HORROW: Ready for petitioners, your Honor.

MR. HOLT: John W. Holt for the respondent.

MR. HORROW: Harry R. Horrow appears for the petitioners, and my associate Stephen J. Martin, appearing for the petitioners.

THE COURT: Proceed gentlemen.

MR. HORROW: If your Honor please, I would like to make a brief opening statement covering the issues in these cases. The cases have been consolidated for a hearing and opinion. They involved Federal income tax deficiencies for 1961, and they arise out of the exercise and sale of rights to purchase common stock of Pacific Northwest Bell Telephone Company, which I shall refer to as Northwest, by individuals who are owners of common stock of The Pacific Telephone & Telegraph Company, which I shall refer to as Pacific.

These rights were issued in connection with a plan for reorganizing the Pacific Company, which was approved by the shareholders of Pacific at its annual meeting in 1961. The principal reasons for the plan were to cope with the enormous growth of the telephone business in the territory served by the Pacific Company.

The Pacific Company operated in the states of [4] California, Oregon and Washington and a portion of Northern Idaho, which is contiguous to Washington and geographically was part of the operating territory of the Pacific Company.

It was felt desirable to divide the business and operations of the Pacific Company and to separate the management of a new corporation that would be created for the Pacific Northwest from the management of the Pacific Company. The plan called for the division of the assets and operations of Pacific between the state of California and the states of Oregon, Washington and this portion of Northern Idaho that I have referred to.

The plan was conditioned upon approvals by the regulatory agencies in the several states in which Pacific operated and the Federal Communications Commission and also certain tax rulings by the Commissioner of Internal Revenue. These approvals were received prior to June 30, 1961, and the Commissioner of Internal Revenue ruled that there was no taxable gain or loss that would occur on the proposed transfer of the assets and operations in the states of Oregon, Washington and Idaho to the proposed new corporation, Northwest.

Accordingly, as of the close of business on June 30, 1961, this transfer took place. Immediately after the transfer Pacific held all of the stock of Northwest consisting of 30,460,000 shares of $11.00 par common stock, a note in the amount of $200,000,000 and certain current liabilities arising [5] out of the operations in Oregon, Washington and Idaho were assumed by Northwest at the time of transfer. The capitalization of Northwest was set up so that proportionately it represented the same proportions of capital, surplus and debt that Pacific had prior to the transfer, and the net assets which were transferred to Northwest represented approximately 20 percent of the total net assets of Pacific.

This plan contemplated that all of the shares of Northwest would be distributed to the Pacific shareholders. Because of the surplus requirements of the California law, Pacific could not effect a distribution of these shares to its shareholders directly. It did not have sufficient earned surplus; it could not create surplus for this purpose under the California law. Therefore, the method for disposing of these shares to the Pacific shareholders which was provided for in the plan was an issuance of rights to purchase the Northwest common stock, and because of the large amount of stock involved, the plan contemplated that this would be done over a three year period. The first offering of these rights occurred in September, 1961; the amount of stock in respect of which these rights were issued amounted to approximately 57 percent of the stock of Northwest. This was done in order to give the American Telephone & Telegraph Company, which I shall refer to as the American Company, more than 50 percent of the stock of Northwest when it exercised the rights which [6] were to be issued in 1961. American, in 1961, owned approximately 90 percent of the common stock of Pacific, and owned approximately 78 percent of the preferred stock of Pacific, representing 89.62 percent of the total voting power of Pacific. The rest of the shares of Pacific were held by the public and were traded on the New York Stock Exchange and the Pacific Coast Exchange. All of the rest of the shares of common stock of Northwest were disposed of in connection with a rights offering in 1963, which was essentially on the same basis as the 1961 offering, and thereafter Pacific did not own any shares of Northwest

stock and American owned approximately 89 percent of the outstanding stock of Northwest.

The deficiency notices in these cases are based on a ruling that was first issued by the Commissioner dated June 28, 1961, and on a request for reconsideration was reaffirmed over a year later on November 15, 1962. These deficiency notices, in line with the Commissioner's ruling, hold that the exercise of rights by these individuals, common shareholders of Pacific, to purchase common stock of Northwest represented a distribution under section 301 of the Code and that distribution was a dividend, taxable to the extent of the difference between the fair market value of the common stock of Northwest at the time of the exercise of the rights and the price paid for the stock, $16.00 a share.

The Commissioner's ruling held that with respect to [7] corporate shareholders there was similarly a distribution of property, namely, Northwest stock, which was covered by section 301 of the Code, but the Commissioner ruled that there was no income unless the basis of the stock in the hands of Pacific at the time of exercise of the rights was in excess of the price paid for the stock, $16.00 a share. The basis of the stock of Northwest in the hands of Pacific was less than $16.00 a share. Therefore, none of the corporate shareholders of Pacific have been held to have received any taxable income by reason of the exercise of rights to purchase the Northwest stock in line with the Commissioner's ruling.

Now the respondent departs somewhat from the ruling and the deficiency notice in each case by alleging in the alternative, that if there was no dividend income re-

sulting from the exercise of the rights, there was dividend income resulting from the issuance or the receipt of the rights, and in the amount of the fair market value of these rights at the time they were issued. The Commissioner specifically ruled in his ruling letter, which I referred to, that the receipt of rights did not result in any taxable income.

THE COURT: Is this additional position one that was taken in the amended answers?

MR. HORROW: It is taken in the respondent's answer in the Gordon case and his amendment to his answer in the Baan case, your Honor.

[8] Now, in the Gordon case, there is another issue involving the tax treatment of the sale of rights; the taxpayers in that case, through inadvertence, did not report any income by reason of the sale of rights, and the respondent affirmatively alleges that ordinary income was received on such sale equal to the total net proceeds received.

Now, what are the petitioners contentions? First of all I would like to point out that the substance of this transaction was to permit the Pacific shareholders, through the exercise of rights, to be in exactly the same position with respect to their ownership in the business assets and operations of Pacific as they were before, and in addition require them to pay $16.00 per share of Northwest stock also, an additional investment of capital in the Pacific Company. In other words, any shareholder who exercised his rights, in our view, in essence had nothing more than he had before and in addition had to invest additional cash in Pacific. Specifically, we rely on section 355.

We agree with the position taken by the Commissioner that there was a distribution of property, a distribution of Northwest stock, and we contend that it is governed by the provisions of Section 355, and that no gain or loss should be recognized through the receipt of Northwest stock in the exercise of these rights.

Now, we have never been informed and the ruling does [9] not disclose the reason why or the reasons why the Commissioner held that Section 355 did not apply. The ruling gives no reasons, the deficiency notice gives no reason, and yet the ruling states specifically that Section 355 does not apply.

In addition, the petitioners rely on the general reorganization provisions that permit an exchange of interests in corporations which are party to reorganization without the recognition of gain or loss. There is no boot here received since the taxpayers who exercised their rights didn't receive any cash, on the contrary they paid money into Pacific and made an additional capital investment.

THE COURT: Well, what section do you rely on for that position?

MR. HORROW: Section 368 is the definition of reorganization. We also rely on the—I believe it is (b)4. I haven't got the Code here, your Honor. It is the provisions that permit the exchange of stock or securities in a corporation—in corporations which are party to reorganization, without the recognition of gain or loss.

THE COURT: Well, I know from your pleadings that you relied on Section 368, but that is merely the definitional section.

MR. HORROW: Section 354.

THE COURT: That is only a starting point. You have got to go from 368 to some operative provision that provides for non-recognition and my inquiry is what operative [10] provision you are relying on.

MR. HORROW: Section 354, Your Honor.

MR. HOLT: If I may say, I think one of the disputes is the application of either 351, and then, specifically, 351(b) to the transfer of property to Northwest or to 368(a)(1)(D). The Respondent's basic position is that the two hundred million dollar demand note was boot, and forced the transfer of property out of 368(a)(1)(D).

MR. HORROW: Well, Your Honor, I didn't want to get into an extended discussion of the legal points. It is true in the course of the consideration of the ruling requests that were made on behalf of shareholders of Pacific, the question was raised as to whether the transfer of the assets of Pacific to Northwest for common stock and a demand note would result in the recognition of gain or loss, except for the consolidated return provisions, which applied here, because the American Company filed consolidated returns for 1961 and '62 and 1963. So in any event, regardless of any legal theory that might otherwise apply with respect to the transfer of the assets of Pacific for common stock and a demand note, no gain or loss would have been recognized by reason of the fact that any such gain that might have been otherwise recognized would have been eliminated as an intercompany transaction.

THE COURT: Well, you are talking about the companies [11] themselves.

MR. HORROW: Yes, sir.

THE COURT: I'm talking about these taxpayers that are before the Court, and about your theory that Section 368 provides the basis for non-recognition, and I was not asking for any argument of counsel; I just wanted to know what your position was. Namely as to what operative provision of the statute you rely upon to give you that non-recognition, assuming that you've established that there was a reorganization under 368.

MR. HORROW: Section 354.

THE COURT: Section 354. Thank you.

There are numerous provisions in that section, and I hope you'll be able to pin-point for me just what it is in 354 that you are relying upon.

MR. HORROW: I assure you, Your Honor, we'll make every attempt to do so, and we feel our briefs will be comprehensive and cover the specific legal points upon which we intend to rely.

Now, there is another alternative position that the Petitioners take, and that is that in the alternative, the distribution of the Northwest stock was a distribution in partial liquidation, which is governed by Section 346, and any amount deemed to be received by the shareholders by reason of such distribution should first be applied against [12] the basis of their stock in Pacific in respect to which the distribution was received, or in any event, to result in a capital gain or loss, rather than dividend income, as the Commissioner has ruled.

On the issue pertaining to the sale of rights, it is contended on behalf of the Petitioners in the Gordon Case that the amounts realized represent the proceeds from the sale of a capital asset, which are either nontaxable as

a return of the basis of the Pacific Company's stock in respect of which the rights were received, or result in capital gain or loss, measured in the difference between the proceeds received from the sale and the allocable portion of the basis of the Pacific stock on which these rights were received.

In any event, we dispute the Commissioner's contention that the proceeds constitute ordinary income. Bear in mind, Your Honor, that the affirmative allegation made by the Respondent with respect to the tax treatment of the sale of rights is that the proceeds, in their entirety, constitute not dividend income but ordinary income, and we contend that if the entire proceeds represent income, they are taxable as dividend income and not ordinary income.

Now, Your Honor, we have transmitted to the Clerk a signed stipulation of facts, together with exhibits. [13] There are certain inked corrections on the stipulation which was turned over to the Clerk. We would like, at this time, to withdraw that stipulation and file with the Court four corrected stipulations of facts which have been signed by the parties.

THE COURT: You may do so.

MR. HORROW: Your Honor, that completes my opening statement.

Your Honor, I would like, also, to ask that the exhibits which are attached to the stipulation be marked "filed", and we would like permission to withdraw any exhibits as may be necessary to provide the Court with clear and easily legible exhibits. Time has not permitted us to provide the Court with exhibits that are clearly easily read, and we would like to do so.

THE COURT: The exhibits which accompany the stipulation have been received by the Court, along with the stipulation, and Counsel may substitute better copies for any of the exhibits which have thus been received.

(Whereupon, the heretofore mentioned stipulation, together with the attached exhibits, were received into evidence by the Court.)

MR. HORROW: Thank you, Your Honor.

All of the exhibits are joint exhibits and are numbered from exhibit one-A to exhibit seventy-four-VVV, [14] inclusive.

MR. HOLT: Your Honor, I believe that Mr. Horrow has fairly well set out the factual background here; the broad factual background. Certainly, the overriding issue in these cases, aside from the transfer of properties from Pacific to Northwest is whether the petitioners, common stockholders of Pacific, received from Pacific a dividend or a dividend in kind in 1961 from the exercise or, alternatively, the issuance to them, of rights to purchase stock of Northwest then held by Pacific. The Respondent has determined that the issuance or exercise of those rights was a distribution of property within the meaning of section 301 of the 1954 Code.

With respect to clarifying perhaps, something that arose earlier, it is the Respondent's position that the transfer of assets to Northwest by Pacific, the concomitant receipt by Pacific of the outstanding stock of Northwest, and the $200,000,000.00 demand note constituted a transfer of property within the meaning of section 351. Under section 351(b) the gain, if any, to Pacific on the transfer is taxable to the extent of the demand note, which is boot.

Now, Mr. Horrow made the point regarding the consolidated return provision, since from its inception Northwest joined in the consolidated return filed by American and its Bell System Affiliates. This gain, if any, was between Pacific [15] and Northwest, affiliates of the Bell System on a consolidated return, and, therefore, any gain which was originally recognized was thereafter eliminated.

THE COURT: Does this have anything to do with these cases?

MR. HOLT: Yes it does, Your Honor. And perhaps we should clarify that point. One of the reasons that Respondent ruled that 355 does not apply in these cases, and 368(a)(1)(D) does not apply, (a)(1)(D) is only applicable if the transfer qualifies under section 355 or other sections.

We say, as one of our positions, that 355 does not apply, since Northwest, under 355, would have had to have received the property which it received from Pacific in a wholly nontaxable exchange. We say this is not true. It's taxable to the extent of the boot under section 351 (b).

Petitioner comes back and says, "Oh, but this was eliminated under the consolidated return provisions, and therefore, there was no profit." But we say "No. It does not cut across subchapter C, and if, under subchapter C, if it was taxable in the first instance, then it is not a wholly nontaxable exchange under section 355 and does not qualify as a 355 transfer."

This is one of the positions under 355, Your Honor, that the Respondent has. With respect to some of the ram-

[61] ifications of some of the alternative positions here, I think it would be fair to say that the Respondent's basic position on this transfer is that it represents a realignment of corporate assets and a divisive reorganization in form, not a corporate liquidation.

This is one of the reasons why Respondent says this does not fit within the context of the corporate liquidation.

I think Mr. Horrow has fairly stated the Petitioner's position, and the various alternatives which he has made.

Another facet of these cases is that the distribution in question came from an operating company of the Bell Telephone System. That system represents about 90% of the telephone industry in this country and also has sizeable foreign investments. There is little doubt that in some ways the Bell system is a unique structure in the American corporate scene.

One of the salient features of that uniqueness is the method by which that system has acquired equity financing and indeed its high ratio of equity to debt in its capital structure. The Bell System is also unique in that the parent American owns 100% of sixteen of its twenty-one operating telephone companies, virtually 100% of one, approximately 90% of three and approximately 70% of the last one. Pacific is one of the few companies in which [17] the Bell owns only 90%.

THE COURT: What does that have to do with it?

MR. HOLT: I think it goes to whether you have a contraction within the meaning of a partial liquidation when you are merely realigning corporate properties within an overall operating unit.

In addition, Your Honor, the Bell System, including Pacific, has traditionally obtained new equity capital by issuing additional shares of common stock through short-term rights at par or at some other offering price which has been, with few exceptions, substantially below market. The amount so below market is sufficiently large in the great bulk of the offerings as to not be justified as a discount necessary to insure the ready marketability of the issuance.

Thus, the question of the economic, financial, accounting and, finally, tax conclusions to draw from such a method of financing becomes a focal point in these cases. This is so since it is also the Respondent's position that the offering of the Northwest stock through rights by Pacific in 1961 was so greatly underpriced as to clearly amount to a bargain purchase of that stock and to fit within the general underpricing concept in marketing common stock as employed by the Bell System.

The Petitioners interpret the distribution of [18] rights to alternatively result in various different conclusions. The Respondent's conclusion is, no matter how you slice it, the Petitioners received property of value from Pacific either on the issuance or exercise of the rights in question and that property of value is taxable as a dividend. The Respondent's witnesses will be directed to an interpretation of the economic, financial, and accounting results of the transactions in these cases, leaving to the Court the ultimate question of the tax results in light of the foregoing.

I would now like to make a couple of comments on Petitioner's Opening Statement. I think the question of

the scope of the petition— the Respondent's statutory notice—should be left to brief. I'm a little surprised that counsel implies that he's never been informed as to our position under 355. There were many conferences and quite a ruling process on these cases.

We have stipulated for the information of the Court, and as a background, two ruling letters that were actually issued by the Respondent and it would seem that this case was fairly well hashed out on an administrative level.

On the question of whether the sale of rights is ordinary income or capital gain, I would merely like to point out that in the ruling, we ruled that it was ordinary [19] income, so that our pleading in this respect is consistent with the ruling which was given the Petitioner.

THE COURT: I'd like to have you state more clearly just what is the status of your alternative position on the question whether the distribution of the rights themselves is to be treated as income as against the question whether income is realized when the rights are exercised and new securities are obtained at a value which is greater than the amount of money paid for the exercise of the rights.

Now, do you have what you might call a primary position and an alternative position, or what? Are these alternative positions presented to the government on an equal footing? Are you asking the Court—well, let me restate it somewhat differently.

Are you asking the Court to rule that income is realized when the rights are exercised and that if you prevail upon that you are not interested in the alternative grounds at all?

MR. HOLT: This, certainly, Your Honor, is the normal course of an alternative argument, and I would presume that would be true here, although I must admit it does bother me, as it bothers the Court. We have a published ruling, Your Honor, in which we have taken the position that in a situation like this, the taxable event is the exercise of the rights.

[20] So our ruling position is certain. We've got to decide, for administrative ease, which date is the date we are going to rule on. We have selected the exercise date because of the Supreme Court decision in Palmer, and the interpretation of the Choate and Gibson case. When these decisions were made in regard to these cases, the Commissioner announced his ruling and published it and acquiesced to some extent.

This position of the Second Circuit resulted from what the Respondent viewed as dictum in the Palmer case, which has caused the taxpayer and Respondent some difficulty in this area. In the Palmer case, at least the findings of fact, as I understand them, show the price at the issuance date of the rights was the price representative of what the stock was worth to the corporation, so as of issuance date, there was nothing that the corporation was giving up, even though it was an underpricing. It was necessary to market stock in that fashion.

Now, certainly, I think it would be the Respondent's position that in a situation in which this is so, the corporation is giving nothing up at this point of time, and the Supreme Court, in dictum, then, in broad dictum, made the conclusions or arrived at the conclusions that

in no event does the corporation give up anything when the corporation issues rights.

[21] Now, we have recent decisions of the courts in the stock option area where the courts have said in the Lo Bue case, before the Supreme Court that the taxable event was date of issuance. There are a lot of textwriters in the area which say the old Palmer rule is wrong, and we alternatively pleaded the issuance date, so if the Court feels that it is not the correct taxable event in a stock right offering of this nature, then we have before the Court the only other alternative date, which is the issuance date.

In other words, Your Honor, the Respondent does not want to lose this case on the grounds of the Court saying there was no taxable event on exercise date if the Court might have decided that at the issue date there is a taxable event, and, of course, the tax consequences are a little different because the values changed and fluctuated throughout this period.

THE COURT: But the primary position that you are asking the Court to adopt is that income was realized when the rights were exercised?

MR. HOLT: This is the principal ruling position of the Respondent, yes, Your Honor.

THE COURT: Your other position is one that you are asking the Court to accept only if you should fail on your principal one.

MR. HOLT: Yes, Your Honor, and I would say this [22] in amplifying that. If it is taxable on issue date, then I don't really see that it could be taxable on exercise date. If the taxable event is issue date, then we

cannot come at a later date of time and say you have to pay taxes on this date.

Therefore, it appears that the Court may, even though this is alternative, the Court may have to approach the question as to which is the right date.

THE COURT: I imagine that this thing could get pretty involved. I can conceive of a situation where—this is extremely hypothetical, but where if the Court should rule that income is received on the distribution of the rights and if the market went up thereafter and the rights were exercised, there might be an increment.

MR. HOLT: That's right.

THE COURT: Upon the exercise of those rights which could provide two points at which the statute might operate.

I would certainly doubt whether any such bizarre situation was ever intended by the statute.

MR. HOLT: Your Honor, the Second Circuit approached this problem and said that since the Supreme Court says there is no taxable event on issue date and since the taxable event could not exceed something of value which the corporation is passing on to the stockholder, we hold the [23] exercise date to be the taxable event, but limit the amount of income received as a dividend to the lesser amount of the income spread between fair market value and offering price on issuance date or exercise date.

In other words, the second circuit says that whichever is the smallest figure, this is the dividend. This is part of the Choate ruling which the Respondent has not adopted in his ruling.

MR. HORROW: Your Honor, I would call as a witness for Petitioner, Mr. John O. Einerman.

[24] JOHN O. EINERMAN

was called as a witness by the petitioner and, having been first duly sworn, was examined and testified as follows:

THE CLERK: Take the stand, please, sir, and state your name and address for the record.

THE WITNESS: My name is John O. Einerman.

My address is 140 New Montgomery Street, San Francisco, California.

DIRECT EXAMINATION

BY MR. HORROW:

Q Mr. Einerman, will you please state your occupation?

A I am the Vice President and Comptroller of The Pacific Telephone and Telegraph Company.

Q How long have you held this position?

A Since March, 1958.

Q Will you briefly state your business experience.

A I entered the Bell Telephone System in 1929 after graduating from Columbia College in the City of New York, with an AB degree. I was first employed by the New York Telephone Company in the accounting department of that company. I transferred to the American Telephone and Telegraph Company, the parent company of the Bell System, in 1946, and was located in the Comptroller's Department of that company.

I was appointed an assistant comptroller of the [25] American Company in 1951. I became a Vice President

of the Pacific Company, leaving the American Company and going to the West Coast on February 1st, 1958.

I was elected Vice President and Comptroller of the Pacific Company on March 28, 1958.

Throughout my entire business experience I have been engaged in accounting and financial work. This has included the interpretation and application of the accounting requirements of regulatory authorities, the establishment of procedures for reporting and processing accounting work, the preparation of financial and other reports, the preparation of tax returns, the testifying before regulatory commissions in accounting and financial matters, the planning and scheduling of issues of securities, and the preparation of registration statements and prospectuses used in the sale of securities.

Q What are your duties and responsibilities as Vice President and Comptroller of the Pacific Company?

A I am responsible for the company's general books and accounting records. I must see that the accounts are maintained in accordance with the system of accounts prescribed by the Federal Communications Commission for Telephone Companies.

I am responsible for the preparation and issuance of the company's financial and administrative reports and the preparation of accounting data for regulatory authorities. [26] I am the administrative head of the company's accounting department.

Q Do your duties embrace financing and security issues?

A Yes. I am responsible for estimating the company's new capital requirements, for recommending the form

and timing of the security issues and planning any financing that is authorized by the company's Board of Directors.

Q Since you came to the company in 1958, how many security issues have you handled?

A Since joining the Pacific Company in 1958, the Pacific Company has had three debenture issues. It has also had two issues of its own common shares, and it has had two issues of the Pacific Northwest Bell shares.

Q Could you indicate the size of these issues, Mr. Einerman?

A The total capital raised through these seven security issues was in excess of one billion dollars.

Q Well, Mr. Einerman, I hand you the stipulation of facts which has been filed in this case, and the exhibits, which are on file with this stipulation.

Are you familiar with the contents of that consolidated stipulation of facts, which I have handed you, together with the exhibits?

A Yes, Mr. Horrow, I have reviewed this material carefully.

[27] Q Are you the John O. Einerman referred to in said stipulation and in certain of those exhibits?

A Yes, I am afraid I am.

Q I direct your attention to Exhibit 17-Q, which is the proxy statement dated February 27, 1961, and I refer to page 8 of said exhibit, "Plan for Reorganization."

Would you state to the Court your role in the development of this plan for reorganization?

A In 1958, shortly after I joined the Pacific Company I was asked by the then President of the company to

undertake studies looking toward the division of the company into two or three separate companies. The problem, basically, of course, was one of the tremendous growth of the telephone system on the Pacific Coast and the fact that the territory then covered by the Pacific Company encompassed about one-seventh of the continental United States, extending all the way from the Canadian border to the border at the South.

I worked with a small group of people within the company and with the company's lawyers, considering various plans which were developed within this small group or which were suggested by this small group.

We analyzed the financial impact of every possible type of procedure that could be followed. We considered the advantages of each plan that was suggested. I was in a position to know the pros and cons of each of these plans, since it was my responsibility to come up with the final [28] recommendations, as to the plan which should be carried through and which in fact was finally carried through. Our studies showed that it would be extremely desirable from an operating point of view to divide Pacific into two companies with separate Boards of Directors, and each company with its own shareholders.

As a result of these studies, the Pacific Company was first divided into separate operating divisions in 1960 and was then divided into separate corporations in 1961.

Q The division into two corporations was pursuant to the plan for reorganization set forth in the exhibit which I have referred to?

A Yes, it was.

Q Mr. Einerman, did you consider as an alternative method the distribution of shares of stock of the proposed new corporation directly to the shareholders of Pacific on a pro rata basis without the payment by such shareholders of any consideration therefor?

A Yes, this was one of the plans that was considered. We were informed, however, that California law would require that a distribution of this type be charged against the company's surplus.

Generally accepted accounting principles would have required that such a distribution be charged against the earned surplus of the company. Pacific did not have a [29] large enough earned surplus to take such a charge. The only possible method that could have been used would have been to set up a reduction surplus out of capital. And we were informed that we could not use such a surplus, such a capital surplus amount under California law again, without first redeeming the company's preferred shares.

The Pacific Company has a small issue. This totals $82 million of preferred shares outstanding, and these shares are noncallable.

MR. HOLT: I will object to that and ask that it be stricken. I think the question as to whether the shares are noncallable becomes a legal conclusion which I do not think this witness is qualified to draw, your Honor.

We have stipulated in the record the facets that go into this question and I think it is a conclusion to be drawn.

MR. HORROW: Your Honor, the witness, as I understand it, is addressing himself to advice given by counsel

in his understanding and consideration of this alternative method.

MR. HOLT: Well, if the testimony is that he was advised that it was noncallable, this is all right.

If he is drawing his own conclusion, that it is noncallable, I submit he is not entitled to do that, your Honor.

MR. HORROW: All right.

[30] BY MR. HORROW:

Q Mr. Einerman, you are stating your understanding that the preferred stock of Pacific was noncallable.

A This is my understanding, based on advice by the company's lawyers.

THE COURT: The answer may stand. Proceed.

BY MR. HORROW:

Q Now, Mr. Einerman——

A So, as a practical matter, we felt that we had to charge the shareholders enough for the stock of the new company so as to avoid any drain on Pacific's earned surplus.

Q Now, Mr. Einerman, there are certain exhibits which you have before you relating to presentations made by you to the Board of Directors of Pacific at various dates. And I will refer to the exhibit covering the Directors' meeting on August 25, 1961, which is Exhibit 34-HH, in the stipulation.

Do you have that before you?

A I now do, yes.

Q Now, I refer you to the portion of that exhibit headed "Factors to be Considered," which is the 8th page of said exhibit.

Will you please explain to the Court the presentation which that page relates to?

A I think it would be well, first, Mr. Horrow, [31] to mention that the first six pages represent the speaking notes which I used in making the presentation to the Directors on August 25, 1961, and the attachments which are numbered 1, 2, 3, 4, 5, 6, and going up to 11, represented charts which I displayed to the Directors as I used the speaking notes which I have referred to.

The particular item that you referred to, chart 2, headed "Factors to be Considered," listed seven factors which I stated to the Directors included the factors that we believed should be considered in setting the selling price for the first offering of Pacific Northwest Bell shares.

These factors, as listed were:

1. The tax status of the rights to be issued.
2. The market value of the shares to be sold.
3. The rights values received in the past.
4. The rights values at various offering prices.
5. The company's requirements for new capital.
6. Proceeds at various offering prices and the shareholders' investment above par; and
7. The taxes to be paid at various offering prices.

Then the following charts explain each of these factors in some detail. And I went through these charts with the Directors, discussing each one of these factors in some detail.

[32] Q What use was made of these factors in your presentation?

A Well, these were the factors which I proposed to the Board of Directors for their consideration. They were all of the factors to my knowledge that were considered by the Board in reaching the decision.

The decision was made——

MR. HOLT: I will object to that, your Honor.

I think the factors employed by the Board goes into the minds of each individual Director.

Now, these were the factors that Management presented to the Board to be considered. Now, whether the Directors considered anything else is a conclusion that this witness is not entitled to draw.

I think he can testify that he presented these factors as a representative of Management.

THE COURT: Sustained.

BY MR. HORROW:

Q Mr. Einerman, did a discussion take place at the Board of Directors' meeting at which you made your presentation?

A Each of these factors were discussed as I presented them. The directors raised questions for clarification with regard to these factors.

Q Were any other factors discussed by any of the [33] Directors present at this meeting?

A No, there were none.

THE COURT: Were you present throughout the entire meeting?

A I was present throughout the entire portion of the meeting at which this subject was discussed, and as soon as the decision was made, I left the meeting to give press releases to the press, so this represented the complete discussion of this subject.

MR. HOLT: I assume your last statement is with respect to anything that was within your hearing, Mr. Einerman.

MR. HORROW: I hope counsel is not implying that the Directors said things that the witness did not or could not hear.

MR. HOLT: No, I don't think so. But I think we want to——

Mr. Einerman is testifying as far as he knows that nothing else was stated, which I think was all right. But I don't think this can conclusively presume——

THE COURT: Were you present when the vote was taken?

THE WITNESS: I was present when the vote was taken.

THE COURT: Were you present when the discussion [34] started?

THE WITNESS: Yes.

THE COURT: And you were there throughout the entire period?

THE WITNESS: Yes. It is customary for this Board to have lunch after each meeting, and I had lunch with them. These are all friends of mine. I talked to them on a first-name basis. It is a very friendly operation.

BY MR. HORROW:

Q In speaking to your friends, Mr. Einerman, on the Board, your discussion as to tax status of rights to be issued, to what did that have reference?

A The tax status that I refer to was the tax status covered by the ruling that we had received from the Internal Revenue Service.

We were not satisfied with this ruling and we had been advised by our attorneys that efforts should be made and efforts were being made to change this ruling, but I did indicate to the Board the tax status as it stood at that time.

Q And as ruled by the Commissioner of Internal Revenue at that time?

A That is correct, sir.

Q Now, in making your presentation of the factors which you have mentioned in fixing the price at which the [35] Northwest shares of common stock should be offered to the Pacific shareholders, did you intend to recommend to the Board of Directors that a dividend thereby be distributed.

MR. HOLT: I object to that, your Honor. I don't think the intention of Management is relevant to this case. I think the question which is relevant is what the Board of Directors did.

And I object, basically on the grounds of relevancy, your Honor, and also, I believe what he intended to do is manifest by what he actually said and what he might have actually had in the back of his mind and that is not brought forth in the documents presented to the Court and these exhibits is again something we can't decide, whether these Directors entertained the same intent or whether it was transferred.

Now, if he is trying to testify that his intent was manifested in the Directors' intent, I say this is indirect hearsay, and he could not impart to them his intent.

MR. HORROW: Well, your Honor, discussions as to the tax treatment of rights in certain of the cases, notably the Palmer case, have made some mention of a question

of whether there was an intent to distribute a dividend through the device or method of issuing rights to purchase assets of the corporation at less than the fair market value of such assets.

Now, this witness is obviously qualified in respect to financing, accounting matters. Clearly he is closely [36] related to the financial policy. He knows when and under what circumstances dividends are intended to be distributed by the Directors, and clearly he should be entitled to testify here as to whether in making this recommendation and making this presentation to the Board, he intended to have the Board distribute a dividend.

I think it is that simple, your Honor.

Now, whatever legal effect it has, that is something for a brief and your Honor's consideration, but just as a pure matter of fact, there may be situations where property of the company can be offered to shareholders at substantially less than market value for the purpose of distributing a dividend and with the intent of distributing a dividend.

No such intent was manifest here and we would like to have the record show that.

THE COURT: Well, the evidence which you seek to get from him is conclusory in character and it really asks the witness simply to pin a label upon something. I don't know how helpful this is going to be to the Court, but I prefer to even in doubtful situations let the evidence in and give it such weight as it may deserve.

Under these circumstances, I will let the witness answer.

Proceed.

[37] MR. HOLT: May I say this. The respondent is not stating that he does not believe Mr. Einerman is qualified to draw his own conclusions as to whether this should be labeled a dividend, at least for accounting and financial purposes. Now, if this is what his testimony is purporting to be, we feel that he is entitled to make those conclusions. Now, if he is trying to impart to the Board of Directors, his intent, I think it is something entirely different, your Honor.

THE COURT: I think it is simply pinning a label upon a situation. It may not be too persuasive to the Court. However, I will let the witness testify and I will give the evidence such weight as I think it can be given.

MR. HORROW: Thank you.

THE WITNESS: What is your——

MR, HORROW: Would you read it back?

(The reporter read the pending question.)

THE WITNESS: The answer is that I did not intend to recommend to the Board of Directors that a dividend distribution be made in this manner.

BY MR. HORROW:

Q Was it your understanding that the Directors, in accepting your recommendation, intended to make a distribution of a dividend?

MR. HOLT: I object, your Honor. This is clearly indirect hearsay here. What is the understanding of the Board [38] of Directors intent is clear hearsay. If they want the intention of the Board of Directors, then they will have to call the Board of Directors, your Honor.

THE COURT: Sustained.

To what extent was this entire transaction entered into for the purpose of obtaining additional funds for Pacific.

THE WITNESS: Your Honor, the Pacific Company had been going to its shareholders and into the investment market generally on the basis of a stock and a bond issue at intervals of 12 to 15 to 18 months, and with its tremendous growth pattern it expected to continue to require that amount of capital, possibly—at the rate we are growing now we require about two hundred million dollars a year. It was our intention to secure capital that was needed to build the telephone plant on the Pacific Coast at the same time as we reorganized this company, so in effect we were substituting the issuance of Pacific Northwest Bell shares to our shareholders for the issuance of Pacific shares that we would otherwise have issued. In other words, this whole plan was devised as a means of keeping capital flowing into the telephone system on the Pacific Coast, at the same time as we were splitting the company and achieving these management advantages that would result from splitting the corporation. So we went to the shareholders with this plan of reorganization, and as basic to the plan of reorganization, the disposition of securities [39] is all tied in with the capital needs of the Pacific Company and that was all written right into the plan, so that we felt that our shareholders knew that this was going on—that they, for a period of time, they were going to get the Northwest Bell shares instead of the Pacific shares.

THE COURT: Well now, can your basic testimony be fairly summarized by saying that the split-up of this company and the way it was achieved had a dual purpose, one, to achieve functional advantages by having two separate managements; and two, as a means for providing

Pacific Company with additional funds. Were these the two basic——

THE WITNESS: Certainly from a layman's point of view, your Honor, this was what we wanted.

THE COURT: Was this the substance?

THE WITNESS: This was the substance, really, of the plan for reorganization. That is correct.

BY MR. HORROW:

Q Mr. Einerman, the company's requirements for new capital were discussed in your presentation to the Board in Exhibit 34HH, which I have referred to?

A That is correct, sir.

Q Is it not true that meeting the company's requirements for new capital was part of the plan for the reorganization of the Pacific Company as spelled out in the plan for reorganization?

[40] A That is correct. It is a basic part of the plan for reorganization that we devised.

Q Now you mentioned these seven factors which you asked the Board to consider in fixing the price of the stock. Did any of these factors have any greater or lesser weight in making your presentation?

A No. These seven factors were all presented with equal weight and I did not emphasize any one or two of them in preference to the others. If you will refer to page 5 of my speaking notes, the last paragraph, you will see how I summarized these seven factors. I said, 'as we have gone through these factors you have probably seen that some of them argue for a high offering price and some of them argue for a low offering price. Where we come out is somewhere in between. And then I mentioned,

in summary, that the figure we recommend is $16.00—it appears to give a good rights value. Not too high or too low. The taxes are kept at a reasonable figure to be paid by the company. The proceeds fit into the company's need for new capital, and this is a point which is raised by his Honor.

Actually, we would have a small amount of cash, thirty-four million of cash after repaying all the outstanding notes, but we would use this after about two months, and then I mentioned that there is a dividend pattern which would tie in with the additional proceeds that the shareholders would pay.

[41] Q Would you please explain that statement for the Court, Mr. Einerman?

A It has been our feeling, consistently, that if we ask our shareholders to invest money in the company that we have an obligation to pay a return to them on that money. It had been our practice for many years to issue our own common shares at par. In this case we were departing from that practice for the first time, and we were selling our shareholders shares at a figure higher than par.

And I pointed out in my speaking notes that we in management felt that we had an obligation to pay a dividend on the additional dollars invested above par.

Q You are referring to cash dividends that would be paid by the Pacific Company?

A I am referring to cash dividends that would be paid by the Pacific Company, and this is spelled out particularly on the last chart in this presentation, chart 11, where I showed that the dividends of $1.14, which we had been paying represented approximately 8 percent of

the par value of the shares, and after the offering, our shareholders would have paid in a total of $87 million in addition. This represented the difference between the $11.00 and the $16—$11.00 par value and the $16.00 offering price.

And the dividend which we recommended, and which was adopted at that meeting of the Board was $1.20, which [42] represented approximately that same 8 percent return on the new amount that had been paid into the Pacific Company. Average per share of $15.12.

I want to emphasize again that I am talking about the cash dividend paid by the Pacific Company.

Q Now, Mr. Einerman, I refer you to Exhibit 45SS, covering your presentation to the Directors on May 4, 1963. Does this exhibit contain your speaking notes, covering your presentation on the recommendation for the price of Northwest shares of common stock to be offered to the Pacific shareholders at that time?

A Yes. This is the presentation which I made to the Board of Directors on May 24, not May 4, which Mr. Horrow mentioned, and this presentation covered the recommendation which I made to the Board with regard to the disposition of the balance of the Pacific Northwest Bell common shares.

Q Were the factors that you asked the Board to consider in passing on your recommendation the same as the factors that you presented to the Board at the meeting in 1961, covered by Exhibit 34HH?

A Here again the factors were exactly the same. If you will refer to attachment 2 to the presentation which I made to the Board of Directors, you will find a copy

of the chart which I again used in making this presentation to the Board of Directors, and this chart included the same seven [43] factors, and I went through and described the same seven factors, just as I had done two years previously.

Q You were present throughout the meeting of the Board with respect to the action on your recommendation?

A Yes, I was.

Q Was there any discussion by any members of the Board of Directors at that meeting on other factors not listed in the chart to which you refer?

A Here, again, just as before, there were questions raised with regard to these seven factors, but none of the questions raised or none of the discussions that followed covered any additional factors, over and above these seven.

Q Was it your intention in making your recommendation to the Board of Directors at that meeting to have the Board of Directors thereby distribute a dividend?

A It was not my intention.

MR. HOLT: Respondent notes the same objection for the record, your Honor.

THE WITNESS: It was not my intention to make that recommendation.

[44] Q Mr. Einerman, would you refer to page 2 of the consolidated stipulation of facts. I refer to the last sentence in the first full paragraph on that page:

"By using the terms in conformance with the provisions of the plan, pursuant to the plan, or like language used herein, the parties do not intend to stipulate that action

or transactions stipulated in connection with such terms are necessarily inseparable one from the other, for the purpose of the application of the so-called step transaction doctrine."

Mr. Einerman, were the offerings of rights to purchase Northwest common stock in 1961 and 1963 inseparable, one from the other?

MR. HOLT: Objection, your Honor. I think the plan speaks for itself in this regard. I think a conclusion as to whether the step transaction doctrine applies to an overall plan is a tax conclusion to be drawn by the Court. This witness' interpretation or opinion as to whether they were inseparable, goes against the best evidence, I think, your Honor, and I think the plan must be allowed to stand or fall on its own merits.

MR. HORROW: Your Honor, I don't think there is any real question here as to the fact that all of these events and transactions were inseparable, and were integral parts of this plan for reorganization.

[45] However, counsel has not stipulated that those transactions were such and the statement is made in the stipulation that the use of the words pursuant to the plan, or in conformance with the plan and like language, do not imply, in any way, a concession that these events and transactions, specifically the offer of the rights in 1961 and '63 were inseparable, and would not have taken place, one or the other, had not both occurred as part of this plan for reorganization.

Now, I think the witness should be entitled to testify to that if the Government insists on injecting some nebulous theory here.

THE COURT: Well, I think the witness' testimony would be more helpful to you, Mr. Horrow and more helpful to the Court if we got him to testify to the facts other than to the labels that are in that last sentence you read.

It would be more convincing to me if you used questions that called for facts that would enable me to come to this conclusion, rather than have him state it in terms of a conclusion.

MR. HOLT: Your Honor, I don't think respondent has any objection to the witness that it was part of corporate management, but to draw the conclusion in interpreting the plan, then I think he is being asked to draw a legal conclusion.

[46] THE COURT: Let me ask the witness.

Would the second step be taken without the first?

THE WITNESS: No, sir. These two steps were just part of the same plan.

THE COURT: And when you took the first step, did you intend to present to the board of directors the taking of the second step?

THE WITNESS: Absolutely, this was basic to the plan.

MR. HORROW: Thank you, your Honor. That is all I have at this time.

MR. HOLT: Cross-examination.

THE COURT: Off the record.

(Discussion off the record.)

THE COURT: On the record.

CROSS-EXAMINATION

BY MR. HOLT:

Q Mr. Einerman, you have testified on direct that you considered the question of distributing the Northwest stock to the stockholders of Pacific through short term rights for nothing. Or not through rights, by just making a straight distribution to them of this asset, but stated that you could not do so by advice of counsel; is this correct?

A That's correct.

[47] Q Then you also testified that part and parcel of this plan was the raising of new financing by Pacific?

A That's correct.

Q Wouldn't it have been inconsistent for you to have considered distributing those rights—excuse me—distributing this stock of Northwest at no value or at no remuneration to Pacific? Wouldn't that have been inconsistent with the thought of raising additional capital?

A Well, not completely so, because there are other ways of raising capital.

Q But that would have been a transaction outside of the transaction here. You could have issued additional shares of Pacific in additional equity offerings, couldn't you?

A That's correct. That's correct.

Q Now, what is your conclusions relating your answers to the confines of the transaction we have here? You feel that distributing the shares of Northwest for nothing would have been inconsistent with the overall goals of your plan?

A Well, I mentioned that there were definite legal and accounting reasons as to why we could not make a distribution.

Q Yes, sir. But I am asking you whether the very premise of issuing this Northwest stock for nothing as a [48] distribution of assets or a dividend in kind to the stockholders of Pacific was inconsistent with the premise that your plan was founded on, the premise that you were going on, the premise of raising additional capital through the sale of this stock?

A Mr. Holt, as I stated, we considered many plans, and the plan that you mention of distributing the shares in the form of a stock dividend was one of the plans that was considered, and we had to eliminate that one immediately, because we were advised by counsel that it was illegal to do this.

Therefore we didn't pay any more attention to that particular plan. We went ahead to develop a plan that we could use.

Q Well, I still don't believe you have answered my question, Mr. Einerman. Would the selling of the Northwest stock—would the distribution of the Northwest stock for no consideration to Pacific, to its stockholders, have been inconsistent with what you have testified was the basic premise and reason for the plan in the first instance?

A As I understand your question, you are asking if we could have done this, would we have been able to achieve this separation in this manner.

Q No, I am asking you whether—you have stated [49] that there were two basic goals. You had a tremen-

dous growth, you wanted to set up new management. Also, you wanted to raise new capital for Pacific.

Would the distribution of the Northwest stock for nothing as a dividend in kind have been inconsistent with these goals in the mind of corporate management?

A It certainly would have been inconsistent with one of these goals because we would have had to turn to another direction to raise the capital that we needed.

Q Well——

THE COURT: It would achieve one goal, but not the other?

THE WITNESS: But not the other.

THE COURT: Does the Government agree that if there had been such a distribution that that would have been a tax-free distribution?

MR. HOLT: No, your Honor, we feel that still is non-qualifying under 355 for various reasons, your Honor, and this was only one of the reasons. Thus, I think, if I may presume on the ruling process, we probably would have ruled that this was a distribution in kind, taxable to the extent of the fair market value of the assets received.

THE COURT: This would not have been a tax-free spinoff, under your view?

[50] MR. HOLT: Yes, this is because of the boot under the $200 million demand note. Pacific did not just receive stock from Northwest in this transfer. They received stock plus a $200 million demand note, which Northwest refunded and paid into Pacific, which they used for additional capital in Pacific's operation.

This put the transaction under 351-B, and made it a partially taxable transfer. The transfer of property in the first instance, to qualify, has to be a wholly nontaxable exchange, and therefore this makes it nonqualifying under 355 for that one reason.

Now, the taxpayers have an argument. They say the consolidated regulation provision which eliminates this gain from the boot, then makes it nontaxable in the first instance, and I think this is an issue——

THE COURT: Is it admitted that this $200 million is boot?

MR. HORROW: Not at all, your Honor. Not at all. The demand note followed the traditional form of financing in the Bell System, and the stipulation shows that from time to time advances have been made to the various operating companies by the American Company, with a demand note given, but no expectation that the advances covered by these demand notes, would be paid other than through long term financing which would take place, when and if market [51] conditions made it advisable to do so.

That is exactly what happened here, as the stipulation shows. So the demand note which was received by the company was a security in our view, and we do not concede at all that it is boot.

I would like to suggest to your Honor that section 355 deals in terms of recognition of gain or loss, and in our view it is clear that there was no gain or loss recognized on the transfer of the assets by Pacific to Northwest and the Commissioner so ruled.

THE COURT: Proceed.

MR. HOLT: May I make one short comment here, which may help the Court.

I think this discussion here highlights one of our problems in this case and that is to what extent and effect should the unique financing aspects of the Bell System, and its affiliates, be employed to enable this system to achieve tax consequences that other corporate taxpayers are not entitled to.

I think this is one of the things that we are attempting to determine here, your Honor.

BY MR. HOLT:

Q Mr. Einerman, you have discussed the various factors that were considered by corporate management and presented to the Board of Directors of Pacific in arriving at the [52] prices which the directors were going to set and management was going to recommend on the offering of the Northwest stock by Pacific by short term rights. The first factor was the tax status of rights to be issued. On page 2 of Exhibit 34HH, you have your discussion of this factor, and as I interpret your discussion, you have concluded that one of the problems is that since the ruling which stated that this would be a dividend also stated that as to the corporate taxpayers there would be no such dividend, then you foresaw a conflict with your noncorporate stockholders, who would be displeased by this discrimination of tax treatment of the corporate stockholders of Pacific.

As I interpret your conclusions there, you conclude that this factor should justify a higher offering price, is this correct?

A That's correct.

Q So that this factor should require as high an offering price, up to the minimum underpricing which the

corporation could entertain, which might be necessary to assure the full marketability of the subscription?

A Well, I can't agree with your statement of what might be the high price. My statement to the board was that this factor by itself would argue for a higher price.

[53] Q All right, fine. Now, the market value of the stock to be sold, this factor you discussed and said it was desirable, other factors being neutral, to sell an asset, i.e., the Northwest stock at or near its market value, so this factor in your mind would argue for a higher price or a price approaching fair market value?

A Again, Mr. Holt, I stated that if there were no other factors in the picture, if you were just considering the sale of an asset, if you were not considering this transaction as part of an overall reorganization plan, it would obviously be to your advantage to sell the asset at as high a figure as possible.

Q Now, on the third factor that you considered, you talked about rights values received in the past.

A Yes.

Q Now, this rights value received in the past, relates, does it not, Mr. Einerman, to the practice of the Pacific stock issuing its equity at par, which has been substantially below the market in the past?

A That's correct.

Q Giving the rights concomitant value or a value attributable to the fair market price?

A That's correct.

Q So, in considering this factor, you analyzed the experience of rights values, which the Pacific stockholders [54] had received in the past and said we must have

some continuity in this offering as it relates to this factor?

A I didn't say necessarily that there should be some continued practice of always providing rights values, but I did say that the shareholders who sell rights, many times, consider the sale of rights as an additional dividend, and certainly those shareholders would be disappointed if rights values did not attach to this offer.

Q And rights values approaching those which had been consistently received in the past by the shareholders?

A Well, I didn't——

Q No, I am asking you.

A Well, I don't believe that. Actually the price that we determined on represented a change in policy over what we had done in the past. The rights values attached to prior issues attached to issues at par and we were departing from that policy at this time.

[55] Q Then, Mr. Einerman, in light of what you just stated do you believe this factor as you presented it to the Board argues for a higher offering price or a lower offering price?

A To give rights values you would have to have a lower offering price.

Q Now, with respect to your factor No. 4, you discuss rights value at various offering prices, and as I read your presentation there, this is more or less a neutral factor, since it is a discussion of what you thought the Northwest stock would probably market for.

A No, I do not think this is a neutral factor, for certainly when you are setting a price with the object of having a successful offering, it has been our experience that you must have reasonable rights values.

Q Yes.

A So, without regard to past history, without regard to future history, you must come up with reasonable rights values, and I presented this chart to discuss this problem with the Board as to the rights values that might result from various market prices of the sale of Pacific Northwest Bell shares.

Q Right.

A Here we were working in a vacuum because this is a new security that was being sold. We didn't know what the [56] market price would be. We assumed that it would run between two times par and two and a half times par. And it actually ended up at the upper level, on the average, during the first offering, but by the time we got to the second offering it was down to the lower range.

Q Of course, this second offering was several years later, in which there had been a change in the stock market at that time.

A It was.

Q The Northwest stock had dropped in '63?

A There had been no change in market values. There had been a change in these particular securities.

Q. There was also a change in the market, I believe. It topped off in '61, about September of '61, and you had your May '62 market drop and it recovered in '63, but most stocks did not recover in '63.

MR. HORROW: I haven't objected to this form of questioning, because this is cross-examination, but I would not like to leave or let stand the comments of counsel here which I believe are objectionable, and I think should be stricken.

THE COURT: Well, his comments are not evidence. If the witness accepts his comments and agrees to them, then they become the witness' evidence, but counsel's statements are not evidence.

MR. HOLT: There is no need to pursue this point [57] either, because I think we have stipulated the stock prices in '61 and '63.

BY MR. HOLT:

Q So that on factor No. 4, Mr. Einerman, you would interpret this as justifying whatever underpricing, or rights value is necessary to insure the marketability of the offering and assure the success of the issues?

A I was not offering any recommendation as to a minimum rights value to insure the success. I was presenting this information to the Board as one of the factors that should be looked upon.

Q Well, Mr. Einerman, I ask you to direct your testimony—isolate each factor.

A Yes, sir.

Q And without considering the overall plan and overall ramifications, I am asking you for your opinion as to what each factor would argue for. I say this factor taken alone, argues for an underpricing sufficient to insure the success of the issue. Do you agree with that?

A I would state it this way, Mr. Holt, I think this factor argues for a lower offering price.

Q Well then, I would ask you to elaborate that.

A Well, a lower offering price.

Q Lower than what, Mr. Einerman?

A You will note that I have a range of prices here, [58] between $11.00 par and a $12.50 book figure up to a

$25.00 top price, and looking at that as the range, I would agree that the lower the price that you set, the higher rights values will result and higher rights values will augur the success of the issue.

Q Then you are agreeing that this factor goes to the success of the issue.

A Oh, yes.

Q Now, on your fifth factor, Mr. Einerman, you discussed the company's requirements for new capital?

A Yes.

Q And on—I think it is page 4 of your statement, you make the statement that the company will be able to use whatever proceeds that are obtained from the offering, so I would assume that you would conclude that this factor argues for a higher offering?

A Not necessarily. I think this factor as I presented it showed the Board how much money we needed at that particular time, and then the next chart showed the proceeds at the various offering prices at the first offering, and they could judge for themselves whether a particular price fit the company's needs.

Q Now, you have testified that your company needs or needed during this period of time, approximately $200 million a year.

[59] A Yes.

Q Now, this is from external sources, is it not?

A That is correct.

Q And that this demand was a demand that you foresaw as a continuing demand from one year to the next in the reasonable future?

A Yes.

Q Therefore, I assume that you would conclude that when you were disposing of an asset of Pacific, and had this large and continuing demand for new capital, that you would want to obtain as much as possible for this asset to meet your capital needs.

A First I can't agree that we were disposing of an asset, as such. We were carrying,——

Q Mr. Einerman——

MR. HORROW: Please let the witness answer, Mr. Holt.

MR. HOLT: Well then, I think the witness is almost testifying contrary to the stipulation. We have stipulated these presentations.

THE COURT: The witness may complete his answer.

THE WITNESS: I wanted to state that I can't agree that the only factor involved here was the disposition of an asset. We were not looking upon this as the disposition of an asset. We were looking on this as a step in a plan for reorganization. And one of the most important factors we [60] considered in this plan for reorganization was to have capital flow into the Pacific Company, as it needed capital.

Now the chart 7, which you referred to before, showed that as of September 30 the company's requirements for new capital were approximately two hundred and forty-five and a half million dollars. I turned to the next chart in discussing this with the Board and showed that at various offering prices we would secure various amounts, and the figure that was finally recommended to the Board of $16 million produced $279 million of proceeds.

MR. HORROW: Of $16.00 a share?

THE WITNESS: $16.00 a share, that is correct.

Now, it was of great interest to the Board of Directors that we not get large amounts of cash over and above the company's requirements, which amounts of cash would sit idle or sit in banks at a very low rate of return, because, again, I pointed out in this presentation, that we felt an obligation to pay our shareholders a return on the investments.

BY MR. HOLT:

Q Wouldn't the answer then, or solution to the question of whether you are raising more capital than you need today be to have sold fewer shares than you have sold and sold them at a higher price.

A No, because here again that would not have met the basic requirement of the plan, that as soon as possible we get the ownership of this company, out of the hands of Pacific management.

[61] Q What you are talking about is that you wanted, after the first offering, you wanted American to own over fifty percent of the stock of Northwest?

A Stated another way, that of course is the result, but what we were really wanting was to relieve Pacific's management of the ownership and the responsibility for this new company.

Q All right. And this relief from management that you testified to, you elected to achieve this by passing over fifty percent of the stock to American.

A That was the way this plan achieved the objective.

Q So the reason you offered fifty-seven percent was to assure that instead of just American and Pacific controlling Northwest together, American owned it all by itself, or controlled it all by itself?

A I think you have just repeated what I said before.

THE COURT: Now, this may not have any relevance to the present controversy, but it just seemed to me that—I have been wondering whether we haven't been really talking "Alice in Wonderland" sort of things when we are talking about what Pacific's desires are in the matter rather than what American's desires are in the matter.

THE WITNESS: May I answer that, your Honor?

MR. HORROW: Is that a question, your Honor?

THE COURT: Well, it is a reflection that certainly [62] poses a question in my mind.

MR. HORROW: I will be glad to take that up with the witness.

THE COURT: I don't know if it is strictly relevant to this case, but it has been running through my mind as the witness has been talking about what the objectives of Pacific were, namely to shed certain management responsibilities, and I think this is probably one of the overall objectives of the plan, but whether it was Pacific's objective as distinguished from American's objective, this thing, I must confess, I have been listening to with a considerable amount of incredulity.

MR. HORROW: Well, I would be glad to ask the witness questions in that regard if your Honor thinks these points should be developed.

THE COURT: Well, perhaps these items are not relevant at all to this matter.

BY MR. HOLT:

Q Mr. Einerman, you were prepared to make a response to the Court. Would you complete that response?

A Well, the response that I would like to make is this: It is always a mystery, I guess, to someone outside

the Bell System to know how the Bell System operates. But basically we operate as a team, your Honor, and the people who—my coordinates in the American Company, and you will remember from my experience that I spent twelve years [63] with the American Company, are people that have the same objectives in effect that I as a part of the Pacific Company's management have. We sit down together in conferences and we determine for the good of the Bell System and for the good of the Pacific Company, it would be desirable to cut down the burden on Pacific's management.

The Pacific Company, since this reorganization, has already grown enough to be larger than it was before the reorganization, in approximately three years, and the Pacific's management, and I am part of it, is carrying probably the heaviest burden of any company in the Bell System.

Now, we sit down at AT&T and we talk over these problems. We are not told to do something. We decide it is desirable to do something and then we work to achieve this.

THE COURT: We will reconvene at two o'clock.

(Whereupon, at 12:50 p.m., the hearing was recessed, to reconvene at 2:00 o'clock p.m., this same day.)

[64] AFTERNOON SESSION

(2:00 o'clock p.m.)

Whereupon,

JOHN O. EINERMAN

resumed the stand and, having been previously duly sworn, was further examined and testified as follows:

CROSS-EXAMINATION (Resumed)

BY MR HOLT:

Q Let me see, Mr. Einerman, we left off I believe with item 5, with the factors to be considered, at least that is my recollection.

A This is still on Exhibit 34.

Q I am sorry, 34HH.

A Yes, sir.

Q Do you have it all right?

A Yes, I do, thank you.

Q Item 6 or the sixth factor is the proceeds at various offering prices and shareholders' investment above par. Now, as I understand your testimony, you are saying that anything you charged for this stock of Northwest, you added it to the investment base for the Pacific stockholders and recomputed that base to determine its relationship per share to the outstanding shares of Pacific?

A That is correct.

Q And it was upon this slightly increased base, as a [65] result of adding these additional dollars to it, that you felt you had a higher base on which you would have to pay dividends?

A Well, we felt that we had received an additional investment from our shareholders and we felt that our shareholders deserve a return on every dollar that they invest in the company.

Q Isn't it normally true, Mr. Einerman, that when you make an equity offering or when you get additional investment from your stockholders that the company expects to make more money per dollar of investment than it has

to pay out per dollar of investment as a dividend to its stockholders?

A You are correct in stating that the company would always expect to earn more on any dollar invested in its business than it has to pay to the investor. Otherwise, there would be very little purpose in seeking additional investment funds. I must qualify this to say that this is what the ordinary business would expect. When you come to a public utility, a public utility must meet the requirements for service to its customers in the area it serves and in many cases, the public utility is required to raise money even though it doesn't expect to get any return on that money at all.

Q Certainly in making your arguments in rate cases before regulatory bodies, you argue for a higher percentage rate of return on your common stock equity than you do, for [66] example, on your bonded indebtedness and so forth and when you arrive at the final figure which you say is the rate of return which should be allowed as a component figure of these?

A Well, you are getting into rate case theory here and what a witness who looks upon rate of return in one way might want to consider. These are certainly factors that would be considered in a rate presentation, but however, from a management point of view, the management of the company expects to be allowed a fair rate of return on every dollar invested in the plant.

Q Yes, sir.

A And it expects securing such a fair rate of return, it will be in position to pay its investors a reasonable return on the dollars that they invest in the business.

Q Mr. Einerman, I don't want to curtail you in any fashion. However, if you would attempt to be a little more responsive to the question, I think that we can get through this a little faster. But if you feel it needs to be qualified, you feel free to qualify it.

A I have some difficulty in accepting the wording that you are using.

Q The original question was, does the company normally in rate cases argue that they are entitled to a higher return on their equity investment than they are on their investment in terms of bonded indebtedness?

[67] A Here again——

Q I would think this is a yes or no answer, isn't it, they either do argue that they are entitled to a higher return on their equity or they don't argue that they are entitled?

MR. HORROW: If your Honor please, I think this is getting pretty far afield. I think the question is of such a general nature it couldn't possibly have any bearing on the issues in this case.

THE COURT: I don't know where it is leading either. However, if the witness can give a yes or no answer, I think we might move along.

THE WITNESS: I am sorry, I just can't give a yes or no answer to that question without qualification of the type that I gave before.

MR. HOLT: All right.

THE COURT: There is one aspect of this that bothers me. As I gather you are thinking, as you have outlined before the recess, it involved increasing the dividends to the stockholders on the theory that they had now put

more money into the enterprise. Yet, at the same time, this whole transaction involved stripping the company of its operation in Oregon, Washington, and Idaho, and thereby eliminating from the corporation a very substantial source of income. So the net effect of this entire transaction was to reduce rather than to increase the sources of corporate earnings, and I rather find myself [68] somewhat at a loss to follow your theoretical need to increase the size of the dividend. And I may add, parenthetically, at this point, I am not sure where all of this is leading and it may not lead any place.

THE WITNESS: I would like to explain what our purpose was and what we were intending to do. Basically, we were attempting to take the dollars that we had invested in Oregon and Washington and realize on those dollars as we needed additional dollars to invest in California. And the whole purpose in disposing of these shares of Pacific Northwest was to give Pacific the dollars it needed in California and we timed the sale of the shares to realize the dollars that we need in California.

Now the other thing that bothers you is why was it necessary at this time to consider a dividend change and this goes to this other factor that I mentioned this morning that there was a change in policy that was occurring at the same time, a departure from this past practice of always issuing shares at par. Had we continued to follow that old practice of always issuing shares at par, the company would have felt no need to increase the dividend because the investment per share would have remained the same. And the company had gone along with a very constant dividend rate for many years while it issued shares at par.

Now in this case, when the decision was reached to issue [69] shares above par, management felt that it had to recommend that the dividend be increased so as to give the shareholders a return on these additional dollars. Had we continued to pay the same dividend rate, they would, of course, have received a return on the dollars representing par, but by increasing the dividend, we proposed to give them a rate of return on the dollars in excess of par.

THE COURT: Par is a completely artificial concept, is it not?

THE WITNESS: Not necessarily. In our particular situation, where you have $100 par for many years, and then we had a stock split, that brought it down, but the split shares were still in relation to this $100, the $100 really was the base on which our dividend had been determined originally. And I think your Honor will find that this procedure has been followed quite generally in utility companies that have consistently been issuing shares above par. Where they have attempted to take advantage of a higher market price by setting their offering price well above par, they have consistently increased their dividend at the same time as they have made new issues of shares. I am most familiar with the California utilities. The electric utilities have followed this practice consistently over the years and practically every time they have gone to the shareholders and offered shares well above par, they have at the same time increased their dividend. And [70] I think their management, just as ours, in this particular case, felt an obligation to pay a return to the shareholders on these additional dollars that were invested above par. And if we refer back to this

chart, if you see the $16.00 offering price, this represented that they were paying us $87 million, which amount was going to be reflected in capital surplus of the Pacific Company. And that capital surplus amount was the amount as to which we felt we should change our dividend rate, so as to give our shareholders an additional return payment on those particular dollars.

BY MR. HOLT:

Q Mr. Einerman, I think maybe I can amplify a little bit what you are saying here. Normally, when you sell a stock at par and the corporation has any surplus, then I assume that par is less than book and this has normally been the case in the offerings of par of Pacific. Is that correct, of their own stock?

A You are drawing a distinction as I see it between par value and book value of the common stock.

Q That is right.

A This is right. The book value will always include, in addition to par, a factor for earned surplus and premium, if any premium has been paid in.

Q Now when you sell a stock at par and it is less than book per share, then the sale of the stock at par reduces [71] the overall book value per share, doesn't it? It dilutes the book value per share?

A It has that tendency.

Q When your book value per share is diluted. Then I presume in following what you are saying, when book value is increased when you sell above par you have to increase your dividend. When you sell at par and reduce your book value, I assume that the countervailing pressure would come about and I assume you would decrease

dividends. And may I ask you, has Pacific ever entertained the thought of decreasing dividends when they sell at par, which is a figure below book?

A You have asked many questions there, Mr. Holt, and I don't know which one to answer.

Q Answer the last one, has Pacific ever entertained the question of reducing its dividend pay out per share through issuing an equity stock at par when such an issuance results in diluting the book value per share of its outstanding stock?

A Obviously it has not, Mr. Holt. This would have the effect of making our shares less attractive than they are and they are already not very attractive to the investor.

Q So in effect you are saying that the coin you are talking about here is a one-sided coin. You don't apply it on both sides, only when you are increasing book value?

A Here again, I can't agree and give a yes or no answer to this. The factor here was a very important factor, [72] the number of dollars that we were realizing in excess of par. These were very important dollars. I mentioned that there is $87 million concerned. Now the type of dilution that you are talking about, working in the other way, only acts with regard to the surplus element and the surplus element normally speaking is a very small element as related to par value.

Q May I ask you whether the concepts you are espousing now are generally accepted concepts in the regulatory processes or whether applying the same concept on both sides of the coin would be better accepted practices?

MR. HORROW: If your Honor please, I think we are getting far afield. The question is obviously argumenta-

tive. I don't know what it develops that is pertinent to the issues here.

THE COURT: What is the relevancy?

MR. HOLT: Your Honor, I was just trying to put this in context. If the answer the witness gave to the Court's inquiry was relevant, then I think he went a little afield, then perhaps placing it in context is perhaps relevant, your Honor.

THE COURT: Suppose we get on. I think we are afield at this point.

MR. HOLT: All right, your Honor.

BY MR. HOLT:

Q Actually, Mr. Einerman, the increment in the investment base is a result of the total number of dollars that [73] Pacific wanted to raise in this transaction, i.e., $289 million or whatever it is they raised in the '61 offering, so that this is your fixed point of departure.

The number of shares that had to be offered to arrive at this fixed base would depend upon whatever offering price you wanted to set on the shares?

A Certainly the amount of proceeds would depend on the offering price, but the number of shares that we were offering here was selected with a particular purpose in mind. That was the matter of getting control of the Pacific Northwest Company out of the hands of Pacific.

Q In that respect, and I don't mean to be facetious in this question, Mr. Einerman, but you have stated that if Pacific owned 51 percent of the Northwest stock, they would have the burden of managing Northwest, which they wanted to divest themselves of.

A That is correct.

Q And then you stated with respect to dealing with American in this transaction, Pacific acted independently and yet Pacific is 90 percent controlled by American. Don't you feel that if over a 50 percent control puts the burden of management on the corporation which owns that percentage of control, then presumably you would conclude that American manages Pacific to the same extent that you are now concluding that Pacific would have to manage Northwest, if Pacific owned [74] 51 percent of Northwest?

A My interest, as I mentioned before, as part of Pacific management, was to relieve Pacific's management of the ownership of these shares.

[75] Q Now the last factor, Mr. Einerman, is taxes to be paid at the various offering prices. As I understand this factor, you entertain a minimum and a maximum tax. Let me clarify one point.

I think Pacific has reported its taxes on the minimum figure and this is the figure which has been incorporated in the consolidated return for both '61 and '63, is that correct?

A Well, here again, we are in a very complicated area, Mr. Holt.

Q Just substantially, there may be variations of this figure——

A I want it understood first, Mr. Holt, that these taxes are basically state taxes.

Q I see.

A And——

THE COURT: And to be paid by whom?

THE WITNESS: To be paid mostly by Pacific. There were some taxes in here that had already been paid by

Pacific Northwest as part of its organization. But the basic variations in here that caused the low figure to go to the high figure were additional dollars that Pacific would have to pay.

BY MR. HOLT:

Q Which is the figure which you have most nearly [76] approached finally in resolving this figure, the lower figure or higher figure?

A These matters are still subject to litigation in the state courts. We have actually made our payments on the basis of the minimum payments, and we have, of course, reported the actual payments in our federal income tax returns.

Q That is fine. Now, with respect to this factor, and taking your lower figure or your higher figure, the difference then, just without arguing any minimum underpricing aspect, let's take the difference between the $16 offering price and $25 offering price.

The difference in taxes on your minimum amount between 16 and 25 is approximately 4 million 3. The difference in your taxes on your higher possible figure between a $16 and a $25 offering price is 7 million 58.

A This, Mr. Holt, relates to the first offering.

Q That is right, I am sorry.

A We were looking at the total offering and here the amounts are considerably higher than that.

Q But it is in relationship, is what I am trying to get to. Now, your proceeds, the difference in your proceeds between the $16 price and the $25 price is $157 million.

[77] A Yes.

Q So that you are obtaining $157 million worth of additional funds for the possible maximum additional tax

burden of 7 million 58. So I presume that this factor would argue for as high an offering price as possible? Isolating this factor in and of itself now?

A No, this does not argue for as high a price as possible. It argues on the other hand for as low a price as possible. The one thing you are overlooking, Mr. Holt, is that the additional dollars that the shareholders pay the company for any price set above $16 are dollars which the company feels are not free dollars but are dollars on which we have to pay a return looking toward the future.

Q That is another factor, Mr. Einerman, factor number 6. I am asking you to relate your answer——

A Let me continue my answer, please. What I am saying, therefore, is that you look at this factor all by itself. In other words, and this is the way I presented it to the board of directors, what taxes does the company have to pay as a result of selecting an offering price.

Our directors are pretty hard headed businessmen, I am sure they had in mind that they were willing to pay a certain number of dollars to the Government to achieve the objective of separating this company into two companies.

Very frankly, the figure that I had had in mind [78] in recommending a solution to the board of directors was that we should be able to make this separation by spending no more than approximately $10 million.

Now, obviously, if we get into a tax burden that is over $10 million or $15 million, we have a plan that will not be acceptable. So from a management point of view, we wanted to keep taxes as low as possible. This is part of our business.

We appreciate that we have to pay our fair share of Government expenses, but we don't like to give our funds away.

Q I think that is all on that point, Mr. Einerman. I would like to just clarify one thing in the record and I am sure we could have done this otherwise had I thought of it before the trial. But in Exhibit 11K, Mr. Einerman——

A I have that.

Q —in the upper portion of it, detail regarding issues of common stock, in the third column, price per share, we have three different offering prices here, two in 1927 and one in 1930, in which the offering price is respectively 130, and 150, and $125.

Now, these are, of course, above par. Now in relationship to the small size of the issue, what were these? Were these stock transferred in exchange for property or were these actually rights offerings which became [79] exceptions to Pacific's general rule that they had never issued any equity at more than par?

A These were not rights offerings. Unfortunately I do not have information with me as to exactly what these issues were for, but I do know they were not rights offerings.

Q Would it be very likely that this was stock exchanged for property received?

A I think it is very likely.

Q Of course in that instance you would want to get market value of your stock?

A Well, I am not sure of that either.

Q I don't want you to draw any conclusions from that if you don't know. With respect to your decision with

respect to advice of counsel as to one of the factors that you certainly had to consider in going over this plan of reorganization, let me ask you within that advice, why was it impossible or deemed inadvisable to sell the Northwest stock to both the common and preferred stockholders of Pacific across the board on a basis as if this type of offering would be fully preemptive? In other words, why didn't you just make it an offering fully to both the preferred and minority?

A This is, of course, one of the plans that was considered. Counsel informed us that there was a possibility that the common shareholders would argue that no portion of [80] this offering should be made prorata to the preferred stockholders.

Q On what basis, if you could amplify that advice?

A Well, one of the bases that they mentioned was that the preferred shareholders have the right to receive a fixed dividend, they have a right to receive voting rights, they have a right to receive pre-emptive rights on issues of Pacific's own shares. That is as far as the requirements of the preferred stock go.

THE COURT: This is nonparticipating preferred?

THE WITNESS: So far as profits are concerned, it is a fixed dividend per share of $6.

MR. HOLT: Cumulative.

THE WITNESS: Cumulative.

THE COURT: Nonparticipating.

THE WITNESS: Nonparticipating in profits of the business, but does have voting rights, it does have preemptive rights.

Counsel told us that there was a possibility that minority shareholders might start suits to stop the re-

organization on the basis that rights were being offered to preferred. At the same time, counsel said that the rights of the preferred shareholder were very uncertain in this area, that there was a possibility that the preferred shareholders, the minority preferred shareholders might [81] attempt to start suits to stop this reorganization.

We developed the plan as it was finally submitted to our shareholders to make an offering to both minority common, and minority preferred, on the same basis as though we were offering this across the board with regard to the regular pre-emptive rights of both classes of shareholders.

BY MR. HOLT:

Q What was the basis for the advice of counsel with respect to any thought that the preferred might have a suit? Are you aware of those considerations?

A Basically, they said that our preferred shareholders had received pre-emptive rights to all issues of the company's own stock and in effect, by selling the Pacific Northwest shares, they would lose those rights and therefore they might take the position that the company was using this reorganization plan as a mechanism to stop the giving of rights to the preferred shareholders.

Q Wouldn't you conclude, though, that since Pacific, as far as the offering of the Northwest stock through rights was concerned, was merely selling some of its assets at a profit or a figure over book, and so long as the fair market value of the assets they were selling was received by the corporation, then no distribution of any property took place to the common stockholder and the preferred could [82] not legitimately have any complaint?

A Well, I can't agree with that because, as I mentioned this morning, basically, this entire transaction was part of a plan of reorganization. We were not selling an asset of the company just as such. The whole transaction was geared to this plan of reorganization.

Q When did Pacific start getting advances again from American after the rights offering of the Northwest stock in '61? As I understand Pacific paid off the American advances which had accumulated up to the time of the rights offering and then they went back and started borrowing again from American through advances. When did they entertain this borrowing again?

A Does your question go to the first offering in 1961?

Q Yes, I am sorry.

A As I recall it, we ended up with about $30 million to $35 million worth of excess cash on our hands after the first offering.

Q After paying off American?

A After paying off American and that would have been in the month of October. I am sure we were in an advance position, that is borrowing from the American Company on advances in no later than December of that year.

MR. HOLT: I have no further questions, your Honor.

[83] MR. HORROW: I have no further questions, your Honor.

Thank you, Mr. Einerman.

MR. HOLT: Thank you very much for your patience.

(Witness excused.)

THE COURT: Has petitioner completed their case in chief?

MR. HORROW: Yes, your Honor.

[Tr. 276]

45 T. C. No. 5

TAX COURT OF THE UNITED STATES

OSCAR E. BAAN and EVELYN K. BAAN, Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

IRVING GORDON and MARGARET GORDON, Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent.

Docket Nos. 949-63, 3949-63. Filed October 19, 1965.

Pacific corporation was engaged in the telephone business in California and other western states. It transferred to Northwest, a newly created subsidiary, the assets used in the telephone business conducted in Oregon, Washington and Idaho. It thus became the owner of all of the Northwest stock which it subsequently distributed through the medium of short-term rights issued to its stockholders. *Held,* the transaction was a tax-free spin-off under Section 355, I.R.C. 1954, and petitioner-stockholders who obtained Northwest stock by exercising their rights did not thereby realize taxable income at that time. *Held further,* amounts realized by a shareholder of Pacific upon a sale of his rights to purchase Northwest stock are taxable as dividend income.

Harry R. Horrow and *Stephen J. Martin,* for the petitioners.

John W. Holt, for the respondent.

[Tr. 277] The Commissioner determined deficiencies against petitioners in Federal income taxes for 1961 in the following amounts:

Oscar E. and Evelyn K. Baan	$284.44
Irving and Margaret Gordon	895.10[1]

The principal question presented in these cases is whether petitioners received taxable dividends upon the exercise of rights issued to them by the Pacific Telephone and Telegraph Company enabling petitioners to purchase shares of its wholly-owned subsidiary, Pacific Northwest Bell Telephone Company. Also at issue is the tax treatment to be given to the amounts realized by petitioners in Docket No. 3949-63 upon the sale of four of the rights received by them.

FINDINGS OF FACT

The stipulation of facts filed by the parties together with the exhibits attached thereto is incorporated herein by this reference.

Petitioners Oscar E. Baan and Evelyn K. Baan, husband and wife, were residents of Sausalito, California, during 1961; they filed their joint Federal income tax return for the calendar year 1961 on the cash basis with the district director of internal revenue in San Francisco, California.

[Tr. 278] Petitioners Irving Gordon and Margaret Gordon, husband and wife, were residents of New York City during 1961; they filed their joint Federal income tax return for the calendar year 1961 on the cash basis with the district director of internal revenue in New York City.

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[1]Petitioners Gordon paid this amount subsequent to the filing of the petition in this case.

At all times during 1961, the Baans owned 600, and the Gordons owned 1,540, shares of common stock of Pacific Telephone and Telegraph Company, which had been purchased by them at various times prior to 1961.

The Pacific Telephone and Telegraph Company (hereinafter referred to as "Pacific") is a California corporation which furnishes communications services, mainly local and long-distance (toll) telephone services, in the State of California. Prior to July 1, 1961, it furnished such services also in the States of Oregon, Washington and a northern portion of Idaho.

Pacific Northwest Bell Telephone Company (hereinafter referred to as "Northwest"), a Washington corporation, has commencing on July 1, 1961, furnished such services in the territory previously served by Pacific in Oregon, Washington and Idaho. Bell Telephone Company of Nevada (hereinafter referred to as "Nevada"), a wholly owned subsidiary of Pacific, furnishes such services in Nevada.

Revenues from telephone services constitute approximately 90 percent of the total operating revenues of the three corporations. Other communications services furnished include [Tr. 279] teletypewriter services, and services and facilities for private-line teletypewriter use, for the transmission of radio and television programs and for other purposes. Revenues are also received from the sale of advertising space in telephone directories.

In each state in which it operates, each of the three corporations is subject to regulation by a state public utility regulatory authority which has power within its jurisdiction to regulate intrastate rates, services and other matters, including but not limited to some or all of the

following: facilities, security issues, valuations, purchases and sales of property, budgets, the assessment of fees for the expenses of such authorities, and contracts and other relations with affiliated corporations. All three corporations are likewise subject to regulation by the Federal Communications Commission with respect to their method of accounting and to interstate rates, lines and services, valuations and other matters. The Federal Communications Commission prescribes a Uniform System of Accounts which it requires telephone companies to use in keeping their books.

American Telephone and Telegraph Company (hereinafter referred to as "American"), a New York corporation, has owned more than 80 percent of the voting stock of Pacific at all times since 1907. Including Pacific, Northwest and Nevada, there were 21 operating telephone company subsidiaries of American in 1961. **[Tr. 280]** Of these operating subsidiaries American owns substantially 100 percent of 15 of them.[2] American owns the following percentages of the outstanding stock of its remaining subsidiaries:

Company	Percent Owned
Illinois Bell Telephone Co.	99.32
Pacific*	89.62
Northwest	89.13
The Mountain States Telephone and Telegraph Co.	86.75
New England Telephone and Telegraph Co.	69.33

*Pacific owns 100 percent of Nevada.

American operates a network of cable, wire and radio circuits and related equipment for intercommunication be-

[2]In two of these companies a small number of directors' qualifying shares are privately held.

tween and through the territories of its telephone subsidiaries and of other telephone companies and for interconnection (including interconnection by underseas cables and by radio circuits) between telephone systems in the United States and those in many other countries or territories throughout the world.

American's telephone subsidiaries, including Pacific and Northwest, furnish local and toll service in the territories in which they operate and toll service between points within and points outside of such territories, toll service being furnished partly in conjunction with American and other telephone companies. American's subsidiaries operate in the District of Columbia and in every state except Alaska and Hawaii. American **[Tr. 281]** estimates that over 90 percent of the toll messages originating in the United States are routed in whole or in part over its lines or those of its subsidiaries.

During all of the year 1961 the capital stock of Pacific consisted of the following:

(a) 820,000 shares of 6 percent cumulative preferred stock authorized with a par value of $100 per share, entitled to 7 votes per share held, of which stock all 820,000 shares were issued and outstanding, with an aggregate par value of $82,000,000; and

(b) 105,000,000 shares of common stock authorized with a par value of $14-2/7 per share, entitled to one vote per share held, of which stock 104,756,943 shares were issued and outstanding, with an aggregate par value of $1,496,527,844.

As of December 31, 1960, Pacific had unappropriated earned surplus in the amount of $192,053,880.76. As of

December 31, 1961, Pacific had $178,935,190.15 of unappropriated earned surplus and a capital surplus of $101,326,128.38. There was a sufficient dollar amount of earnings and profits of Pacific in 1961 from which a 1961 dividend could have been paid by Pacific to its stockholders, to cover the dollar amounts which the Commissioner contends were received by the petitioners in these cases and by the other shareholders of Pacific in 1961 with respect to the distribution of Northwest stock. At all times during 1961, Pacific's long-term funded debt was $902,000,000.

Pacific has from time to time carried out its temporary financing by means of advances from American. These loans are evidenced by demand notes due one day after date of issuance, [Tr. 282] which bear interest at 4½ percent per annum. Normally, Pacific discharges such advances through the use of the proceeds from its issuance and sale of its common stock and long-term debentures. The year end balance of such advances on Pacific's books and records, in millions of dollars, for the years 1956 through 1963 were as follows:

Year	Year End Balance
1956	$ 56
1957	82
1958	11
1959	161
1960	134
1961*	-0-
1962	140
1963	49

*As of June 30, 1961 advances outstanding amounted to $233,000,000.

American at all times during 1961 owned 90.25 percent of the outstanding common stock and 78.17 percent of the outstanding preferred stock of Pacific, representing in the aggregate 89.62 percent of the total voting power of Pacific.

The minority common and preferred shares of Pacific are publicly held. At the time of Pacific's annual shareholders' meeting in 1961 it had over 38,000 shareholders. For several years prior to 1961, during all of 1961, and at all times since 1961 the common shares and preferred shares of Pacific have been listed for trading on the New York Stock Exchange and the Pacific Coast Stock Exchange.

[Tr. 283] Commencing with the year 1907, Pacific has employed the calendar year as its accounting year and has kept its books of account to the extent permitted by law on the basis of the accrual method of accounting. Commencing with the year 1914, Pacific has filed its Federal income tax returns on the basis of the calendar year and to the extent permitted by law on the basis of the accrual method of accounting. Since January 1, 1913, Pacific has maintained its accounts in accordance with the Uniform System of Accounts for telephone companies prescribed originally by the Interstate Commerce Commission and since July 1934 by the Federal Communications Commission. For the taxable years 1924 through 1931, Pacific filed, as the parent corporation, consolidated Federal income tax returns with its own subsidiaries. For the taxable years 1932 through 1953, Pacific filed separate corporate Federal income tax returns. For the taxable years 1954 through 1962, Pacific was included as an affili-

ated subsidiary in the consolidated Federal income tax return of American. Commencing with the taxable year 1961, this consolidated Federal income tax return, with American as the parent corporation, included and was filed in behalf of Northwest as well as the other affiliated corporations. In none of the consolidated Federal income tax returns of American and its affiliates for the taxable years 1954 through 1962 did the members of the affiliated group elect, as permitted under Section 1.1502-31(b)(1) of the Income Tax Regulations, to take into **[Tr. 284]** account in the computation of consolidated taxable income the gains and losses reflected in certain intercompany transactions.

The parties have stipulated that "for more than five years prior to June 30, 1961, the operations of Pacific in the States of Oregon, Washington and a northern portion of Idaho, constituted one or more telephone communications businesses operated by Pacific which were separable from the telephone communications business operated by Pacific in the State of California". At all times after June 30, 1961, Pacific has continued in the operation of the telephone communications business in California, and Northwest has engaged in the operation of that business in Oregon, Washington and part of Idaho.

Between the end of World War II and January 1, 1961, there was a substantial increase in the demand for telephone service in the area served by Pacific. The number of telephones increased almost threefold from 2,700,000 to about 8,000,000. The investment in telephone plant (without deducting the depreciation reserve) increased more than fivefold from $662,000,000 to $3,402,000,000;

and annual operating revenues increased more than fourfold from $243,000,000 to $1,120,000,000. The operations of Pacific in the single State of California in 1960, in terms of plant investment and operating revenues, exceeded those of the entire company in California, Oregon, Washington and Idaho in 1957, and the operations of Pacific in Oregon, Washington and Idaho in 1960 almost equalled those for the entire company at **[Tr. 285]** the end of World War II. Growth in all the Pacific Coast states was continuing in 1961 at a rapid pace. Recent studies had predicted the population of California would increase from about 16,100,000 at the end of 1960 to more than 20,000,000 in 1970. Large population increases were also expected in the other states in which Pacific did business.

In terms of total capital, Pacific at the end of 1960 was the largest subsidiary corporation in the Bell System and the eighth largest non-financial company in the nation. On the same basis Northwest, as of July 1, 1961, was larger than eight and smaller than twelve of the other Bell System subsidiaries. It was the largest public service company in the Pacific Northwest area.

John O. Einerman, formerly an officer of American, has been vice president and comptroller of Pacific since March, 1958. Shortly after he joined Pacific Einerman was asked by the president of the company to undertake studies looking toward the division of Pacific into two or three separate companies. The basic problem which brought forth the need for such studies was understood by Einerman to be the tremendous growth of the telephone system on the Pacific Coast and the fact that the territory covered by Pacific encompassed about one-

seventh of the continental United States. He worked with a small group of people within the company and the company's lawyers considering **[Tr. 286]** various plans which were developed within this group. That group analyzed the financial impact of the various procedures that they considered. Einerman concluded that the studies showed that it would be extremely desirable from an operating point of view to divide Pacific into two separate corporations. As a result of the studies Pacific was divided into two separate divisions in 1960 and was then divided into two separate corporations in 1961.

In a meeting on January 27, 1961, the board of directors of Pacific resolved to submit to the shareholders of Pacific a plan entitled "Plan For Reorganization of The Pacific Telephone and Telegraph Company" (hereinafter referred to as the "Plan") for consideration at the annual meeting of the shareholders on March 24, 1961. At the request of the chairman, Einerman addressed Pacific's board of directors and explained the need for and purposes of the Plan, prior to the vote on the pertinent resolutions.

The reasons given for dividing the operations of Pacific were the size of the area served by the company (about one-seventh of the area of the mainland states); the rapid growth of the population of the area since World War II with increases in the number of telephones, and the amount of plant investment and operating revenues; and the expected continued growth of the population of the area with a continuing increase in the amount of telephone service required.

[Tr. 287] The advantages of having a separate division which had been set up in 1960 to run the operations of Pacific in Oregon, Washington and Idaho were considered by management to be as follows:

1. Top authority closer to communities served.

2. Better recognition of service needs of each community.

3. More flexibility in dealing with customers.

4. Closer relations with employees.

5. Better understanding by public and authorities.

6. More efficient operations.

In addition, the following advantages were expected to be gained by the establishment of the Northwest Division as a separate corporation:

1. Financing problems, as well as operating problems, would be assumed by Pacific-Northwest management.

2. A board of directors with final authority, drawn from the territory served, would replace the then-existing advisory boards.

3. The Pacific Company management would be able to concentrate full attention to the needs of California and Nevada.

Under the terms of the Plan, the board of directors of Pacific was to cause a "New Company" to be incorporated under the laws of the State of Washington. The Plan further provided that:

> [Tr. 288] 3. The Pacific Company shall transfer to the New Company all of the business and properties of the Pacific Company located in the States of

Oregon, Washington and Idaho, including all property, whether real or personal, tangible or intangible, franchises, easements, rights-of-way, licenses, leases and all rights of any nature, whether existing or contingent at the time of transfer, arising out of or in connection with its business in the States of Oregon, Washington and Idaho, all of the foregoing being transferred in consideration for (i) the assumption by the New Company of all liabilities, whether existing or contingent at the time of transfer, of the Pacific Company relating to the business of the Pacific Company in such states, except liabilities with respect to any dividends declared on stock, income taxes for which liability reserves have been established and principal of and interest on the debentures and short term debt of the Pacific Company, and (ii) capital stock and debt obligations of the New Company in a total amount which will bear substantially the same relationship to the net book cost of the assets transferred and liabilities assumed as the total of the par value of the stock (common and preferred) and the aggregate principal amount of the debt obligations of the Pacific Company bears to the net book cost of all its assets less liabilities prior to said transfer, the par value of capital stock, debt obligations and surplus of the New Company to be in substantially the same proportions as the par value of stock (common and preferred), debt obligations and surplus of the Pacific Company prior to said transfer.

4. The Pacific Company shall offer to its shareholders as set forth below the right to purchase all of the shares of capital stock of the New Company acquired pursuant to this Plan. The number of shares to be offered to the shareholders of the Pacific Company in any one offering, the number of offerings to

be made, and the price at which said shares shall be offered to the shareholders of the Pacific Company shall be determined by the Board of Directors of the Pacific Company in its sole discretion, provided, however, that each offering shall be made to the shareholders of the Pacific Company on the following basis:

[Tr. 289] a. The holders of record, on such date as may be specified by the Board of Directors of the Pacific Company, of the common shares of the Pacific Company will receive rights to purchase stock of the New Company on the basis of a pro-rate offering entirely to such holders, subject to the following provisions. The holders of record, on such date, of the preferred shares of the Pacific Company other than American Telephone and Telegraph Company will receive rights to purchase such stock on the basis that each such holder of preferred shares, for each preferred share held, will receive seven times the number of rights to purchase stock of the New Company that holders of common shares will receive for each common share held. The rights to participate received by such holders of preferred shares will come from rights which American Telephone and Telegraph Company would otherwise receive with respect to its common shares.

b. In connection with the final offering of the shares of stock of the New Company, shares not sold upon the exercise of rights may be sold by the Pacific Company to American Telephone and Telegraph Company.

The sale of the Northwest stock through the issuance of rights to the shareholders of Pacific pursuant to the

Plan was intended to serve the purpose of providing Pacific with additional capital funds required by Pacific for future operations in California. In each of the seven 12-month periods ended June 30, 1960, Pacific issued additional common stock and/or long-term debentures. The proceeds from the sale of those securities, net of expenses and premiums, were $1,313,750,000, or an average for each of the seven years 1954-1960 of **[Tr. 290]** $187,678,600. In the 36-month period from July 1, 1960, through June 30, 1963, Pacific did not issue any additional common stock or debentures.

Before adopting the Plan, the management of Pacific considered various alternative proposals concerning the distribution of the Northwest shares. One such proposal was the distribution of the Northwest shares to the shareholders of Pacific without the payment by them of any consideration. This was dropped because Pacific's management was advised by its attorneys that it would be required to charge such a distribution to earned surplus, and it had insufficient surplus for this purpose. Pacific's management was advised that it could create a reduction surplus out of capital against which a distribution of the shares of Northwest could be charged, but such a reduction surplus would be required under California law to be used first to redeem all of the preferred shares of Pacific. Pacific's management was advised and believed, although possibly erroneously, that under California law Pacific's preferred shares were not subject to redemption. In addition, the desire of Pacific to raise new capital from the distribution of the Northwest shares would not have been fulfilled by such a method.

On March 24, 1961, a meeting of the shareholders of Pacific was held at which the Plan was approved and adopted, subject to consent and approval by the Federal Communications Commission [Tr. 291] and the public utility regulatory authorities in each of the States of Oregon, Washington and Idaho. At that meeting, Einerman addressed the shareholders regarding the Plan, setting forth substantially the same material that he has presented at the directors' meeting.

Pursuant to the Plan, Northwest was organized under the laws of the State of Washington on March 27, 1961, with an authorized capital stock consisting of 50,000,000 shares of one class common stock with a par value per share of $11. On March 28, 1961, 10,000 shares of such stock were issued by Northwest to Pacific upon the payment by Pacific of $110,000 in cash.

On March 31, 1961, Pacific and Northwest submitted to the Public Utilities Commissioner of Oregon a joint application for an order authorizing Pacific to sell and Northwest to purchase the business and properties of Pacific in the State of Oregon and for certain related orders. On the same date, Pacific and Northwest submitted to the Washington Public Service Commission a joint application for an order authorizing Pacific to sell and Northwest to purchase the business and properties of Pacific in the State of Washington and authorizing the issuance of common stock and debt obligations of Northwest and the acquisition thereof by Pacific. On the same date, Pacific and Northwest submitted to the Idaho Public Utilities Commission a joint application of Pacific to withdraw its tariffs from Idaho and of [Tr. 292] North-

west to file tariffs with the Commission for Idaho. On April 3, 1961, Pacific and Northwest filed with the Federal Communications Commission a joint application for a certificate to the effect that the present and future public convenience and necessity required the acquisition and operation by Northwest of the interstate toll lines of Pacific located in the States of Oregon, Washington and Idaho, and for a certificate to the effect that neither the present nor future public convenience and necessity would be adversely affected by the discontinuance of interstate telephone and telegraph services by Pacific over the lines to be acquired by Northwest.

On May 15, 1961, the Idaho Public Utilities Commission issued its approval order; on June 5, 1961, the Washington Public Service Commission issued its order granting its approval; on June 12, 1961, the Public Utilities Commissioner of Oregon issued his order granting his approval; and, on June 15, 1961, the Federal Communications Commission issued its approval order and certificate.

At a meeting of the board of directors of Pacific on June 30, 1961, the transfer of assets from Pacific to Northwest as contemplated by the Plan was approved. As of 11:59 p.m. on June 30, 1961, all of the business and properties of Pacific in the States of Oregon, Washington and Idaho were transferred to Northwest in consideration for:

> **[Tr. 293]** (a) the assumption by Northwest of outstanding liabilities relating to the operations of Pacific in such states, with the exception of liabilities with respect to dividends declared on stock, income taxes for which liability reserves had been established

and principal of and interest on debentures and short-term debt of Pacific;

(b) the issuance to Pacific by Northwest of a promissory note payable on demand in the principal amount of $200,000,000 bearing interest at the rate of 4½ per cent per annum; and

(c) the issuance to Pacific by Northwest of an additional 30,450,000 shares of its $11 par value common stock, having an aggregate par value of $334,950,000.

As contemplated by the Plan, as of the close of business on June 30, 1961, Pacific ceased operation of the business in the States of Oregon, Washington and Idaho, and as of July 1, 1961, Northwest commenced operation of the business received from Pacific in the States of Oregon, Washington and Idaho.

The par value of stock, aggregate debt (including advances from American evidenced by promissory notes due one day after issue), surplus per books and net book cost of assets less liabilities (a) of Pacific immediately prior to the above-mentioned transfer and (b) of Northwest as of commencement of business on July 1, 1961, were as follows:

[Tr. 294]

	(a) Pacific		(b) Northwest	
	Amount	Percent	Amount	Percent
Stock	$1,578,527,844	54.0	$335,060,000	58.0
Debt:				
Funded	902,000,000			
Advances from American	233,000,000			
Demand note			200,000,000	
Total debt		38.9		34.7
Surplus	207,043,321*	7.1	41,986,477**	7.3
Total Capitalization***	$2,920,571,165	100.0	$577,046,477	100.0

* Before reduction by retroactive depreciation adjustment.

** Before reduction by retroactive depreciation adjustment and by capital stock expense.

*** Equal to net book cost of assets less liabilities.

The total capitalization of Northwest was arranged in such a way as to maintain substantially the same ratios of stock, aggregate debt and surplus as those of Pacific as set forth above. The approximate aggregate par value of capital stock of Northwest to be outstanding having been thus determined, the $11 par value per common share and the approximate number of common shares of Northwest to be outstanding were determined by March 27, 1961, the date of incorporation of Northwest. The $11 par was selected, after review of the normal relationship between par value and market price of the common shares of Pacific's stock, with a view to a price range for the common shares of Northwest's stock which would be most attractive to investors. It was believed that the relationship between the [Tr. 295] price range at

which the Northwest stock would be traded on the exchange and the book value of the Northwest stock would be approximately equal to the relationship between the price range at which the Pacific common stock would be traded and the book value of the Pacific common stock, such future price range of Pacific common stock being forecast in the light of the current prices of Pacific common stock.

On the 1961 consolidated income tax return filed by American and its subsidiaries the transfer of assets from Pacific to Northwest was treated as a transaction coming under Section 351. It was reported that Pacific received from Northwest 30,450,000 shares of Northwest common stock; no securities of Northwest; no money; and other property in the form of a $200,000,000 demand note of Northwest. Since both Pacific and Northwest were included in a consolidated return in the year of the transfer, no gain or loss was reported on the transaction.

From March 28, 1961, until September 29, 1961, Pacific was the sole shareholder of Northwest. Pursuant to the Plan, on September 29, 1961, Pacific issued to its shareholders rights, evidenced by assignable warrants, to purchase 17,459,490 shares of the common stock of Northwest, constituting approximately 57.3 percent of the total outstanding common shares of Northwest.

In conformance with the provisions of paragraph 4(a) of the Plan, each minority common shareholder of Pacific of record at the close of business on September 20, 1961, was issued one **[Tr. 296]** right for each common share of Pacific so held. The number of common shares of Pacific

so held by minority shareholders was 10,214,804. At the close of business on September 20, 1961, American held 94,542,139 shares of common stock and 640,957 shares of preferred stock of Pacific. Under the Plan, 1,253,301 rights were received by the minority preferred shareholders of Pacific on the basis of seven rights for each preferred share of Pacific held by them. These 1,253,301 rights came from rights which American would otherwise have received with respect to its common shares of Pacific, on the basis of one right for each common share of Pacific which American held. Consequently, American received on September 29, 1961, 93,288,838 rights with respect to its 94,542,139 common shares of Pacific. American received no rights with respect to its preferred shares of Pacific.

Under the terms of the offering, six rights and the payment of $16 were required for the purchase of each share of common stock of Northwest. The rights were required to be exercised no later than October 20, 1961.

The common stock of Northwest was listed on the American Stock Exchange and on the Pacific Coast Stock Exchange, and trading with respect to the shares of such stock commenced on September 14, 1961, on a when-issued basis. The rights issued by Pacific on September 29, 1961, were admitted to trading on the American Stock Exchange and on the Pacific Coast Stock Exchange and trading with respect to said rights commenced on September 14, 1961, on a when-issued basis.

[Tr. 297] Petitioners Baan exercised all of the 600 rights issued to them which entitled them to acquire 100

shares of common stock of Northwest and paid to Pacific $1,600 in cash ($16 per share) on October 11, 1961. Petitioners Gordon exercised 1,536 of the 1,540 rights issued to them which entitled them to acquire 256 shares of common stock of Northwest and paid to Pacific $4,096 in cash ($16 per share) on October 5, 1961. On October 5, 1961, petitioners Gordon sold the four rights to purchase Northwest stock which they had received from Pacific but did not exercise. The net proceeds from the sale of the four rights were $6.36.

The fair market values on selected dates of Pacific common and preferred stocks, as shown by the average of the high and low quotations on the New York Stock Exchange (the principal market in which such stocks were traded), and Northwest common stock, and the rights issued by Pacific to purchase Northwest common stock as shown by the average of the high and low quotations on the American Stock Exchange (the principal market in which such stock and rights were traded) were as follows:

Date	Pacific Common	Pacific Preferred	Northwest Common	Rights
1961				
Jan. 27	35.1250	149.0625		
June 30	37.6875	155.0000		
Aug. 25	43.5000	169.0000		
Sept. 14	42.2500	164.9375	29.8125	2.234375
Sept. 29	38.6250	142.5000	26.8125	1.765625
Oct. 5	39.4375	146.0000	26.0000	1.65625
Oct. 20	38.0000	150.5000	27.8125	1.953125

[Tr. 298] As a result of the offering, the minority common and preferred shareholders of Pacific or their

assignees acquired by exercising rights 1,897,891 shares of common stock of Northwest, and American (after purchasing two additional rights privately) on September 29, 1961, acquired all of the 15,548,140 shares of such stock for which it had received rights. The 17,446,031 shares of Northwest thus acquired by the shareholders of Pacific or their assignees by exercising rights had an aggregate fair market value of $468,852,920 at the various dates of exercise of the rights. Pacific received by reason of such acquisitions, cash in the amount of $279,136,496, of which amount $248,770,240 was received from American by its check dated September 29, 1961.

In the consolidated income tax return filed by American and its affiliated companies for 1961, gain was reported by Pacific on the sale of the 1,897,891 shares of Northwest common stock by Pacific to its minority common and preferred shareholders in the amount of $8,739,362.07. Since both American and Pacific were included in a consolidated return for 1961 no gain was reported on the sale of 15,548,140 shares of Northwest common stock by Pacific to American.

The offering price of $16 per share to Pacific shareholders of the portion of the common stock of Northwest offered to them in 1961 was determined by Pacific at a meeting of its board of [Tr. 299] directors on August 25, 1961. At such meeting Einerman, at the request of the President of Pacific, outlined to the board of directors the reasons therefor.

In addressing the board Einerman stated that there were two basic decisions to make in connection with the

first offering of Northwest shares: (1) the price to be set for each share; and (2) if the price set was in excess of par value whether a change should be made in Pacific's dividend to compensate the shareholders for the additional capital invested in Pacific. He then discussed the time schedule that had been established for the offering, all of the dates of which fell in 1961. The necessary registration statement was to be filed with the Securities and Exchange Commission on August 25, its effective date was scheduled for September 13. When-issued trading in the Northwest stock and rights would commence on September 14, and the stock would go ex-rights on September 15. The appropriate stockholders of record of Pacific on September 20 would receive such rights which would be mailed to them in the form of stock warrants together with a prospectus on September 29. Such warrants would expire if not exercised by October 20.

Seven factors were presented for consideration in setting the offering price for the Northwest stock to be sold through rights in 1961. There were questions raised during this presentation with regard to these seven factors but none of the questions raised nor any of the discussion that followed uncovered any **[Tr. 300]** additional factors over and above the seven, and equal importance was given to each. Those factors listed on a chart which was used to present them to the board as "factors to be considered" were as follows:

1. Tax status of rights to be issued.
2. Market value of shares to be sold.
3. Rights values received in the past.

4. Rights values at various offering prices.
5. Company's requirements for new capital.
6. Proceeds at various offering prices and shareholder's investment above par.
7. Taxes to be paid at various offering prices.

Some of these factors argued for a high offering price whereas the others tended to support a low offering price.

In behalf of Pacific's management Einerman recommended to the board, after giving appropriate weight to all seven factors, that the offering price for the Northwest shares to be sold through rights be set at $16 plus six rights. All of management's recommendations as made to the board by Einerman on August 25, 1961, were approved, and the rights were issued as set forth hereinbefore.

In order to insure the success of a distribution of stock through an issue of rights, the difference between the fair market value of the stock and the option price, referred to as the underpricing, must be sufficiently large in two respects. **[Tr. 301]** First, the underpricing in terms of dollar amount must be large enough to make it worthwhile for shareholders to sell their rights if they do not choose to exercise them. Normally a cash value of $.20 for each right would be adequate. Secondly, the percentage of underpricing must be large enough to make the purchase of the stock a good investment, and insure that the rights will be exercised. Taking into account that the issuance of Northwest stock by Pacific was not under-

written, the maximum underpricing necessary to insure the success of the issue would have been 10 percent.

On April 22, 1963, pursuant to the Plan, Pacific's board of directors resolved to offer the remaining 13,013,969 shares of common stock of Northwest held by it to the shareholders of Pacific of record on June 4, 1963. On June 12, 1963, Pacific issued to its shareholders rights evidenced by assignable warrants to purchase all such shares at a price of $16 per share, exercisable at any time before the close of business on July 3, 1963. Rights were received by the minority common shareholders, minority preferred shareholders, and American, the common parent corporation of Pacific on the same basis as the 1961 offering of Northwest shares, except that American relinquished rights to purchase 8,829 shares of Northwest which it would otherwise have received under the Plan with respect to its common shares of Pacific, so that the minority common and minority preferred **[Tr. 302]** shareholders of Pacific could be offered shares of Northwest on a one-for-eight basis. The exercise of eight rights was required for the purchase of each share of Northwest.

As a result of the 1963 offering, the minority common and preferred shareholders of Pacific or their assignees acquired by exercise of their rights 1,416,552 shares of Northwest, and American acquired the balance at $16 per share, including the 11,580,456 shares for which it had received rights which it exercised, and 16,961 shares also acquired by American, as provided in the Plan, constituting the shares offered to the minority common and preferred shareholders of Pacific for which shares the

rights were allowed to lapse by such shareholders, or a total for American of 11,597,417 shares. In the two offerings, in 1961 and 1963, American thus acquired a total of 27,145,557 shares of Northwest, or about 89.1 percent of its single class of common stock.

The offering price of $16 per share to Pacific shareholders for the portion of the common stock of Northwest held by Pacific in 1963 and offered to the shareholders through rights in 1963 was determined by Pacific at a meeting of its board of directors on May 24, 1963. That determination was based upon the same factors which were presented to the board in regard to the setting of the offering price on the 1961 offering of Northwest stock by Pacific.

[Tr. 303] In response to requests by Pacific, the Commissioner issued a ruling letter on June 28, 1961 regarding the tax consequences of the planned division of Pacific and distribution of Northwest stock to the shareholders of Pacific through an issue of rights. In regard to the issuance of the rights and the distribution of the Northwest stock the Commissioner ruled as follows:

> (6) The receipt by the shareholders of the Pacific Company of rights to purchase shares of stock of the Northwest Company will not result in taxable income to the shareholders.
>
> (7) No taxable income will result to the shareholders of the Pacific Company by reason of holding the above-described rights to purchase shares of stock of the Northwest Company until the date of expiration of the rights, without having exercised, sold or exchanged them.

(8) The full amount realized by the shareholders of the Pacific Company upon the sale or exchange of the above-described rights to purchase shares of stock of the Northwest Company will constitute ordinary income to the shareholder so selling or exchanging the rights.

(9) The receipt by the shareholders of the Pacific Company of stock of the Northwest Company upon the exercise of the above-described rights, in case of each shareholder which is not a corporation, will result in a distribution of property under section 301 of the Code in an amount equal to the excess, if any, of the fair market value of the stock of the Northwest Company at the time of the exercise of the rights over the amount paid for the stock; and, in the case of each shareholder which is a corporation, will result in a distribution of property under section 301 in an amount equal to the excess, if any, of the basis of the stock of the Northwest Company in the hands of the Pacific Company at the time of the exercise of the rights over the amount paid for the stock, assuming the basis of such stock is less than its fair market value.

[Tr. 304] On November 15, 1962, the Commissioner issued another ruling letter to Pacific which reaffirmed the positions taken in the ruling of June 28, 1961, as set forth above.

Opinion

Raum, *Judge:* American Telephone and Telegraph Company ("American"), a New York corporation, owned all of the stock or at least a controlling interest

in the stock of some 21 corporations engaged in the business of furnishing telephone and other communications services within the United States. In the aggregate, American and its various subsidiaries comprise what is sometimes referred to as the Bell System. Its stock ownership in its west coast subsidiary, Pacific Telephone and Telegraph Company ("Pacific"), represented some 89 percent of the latter's voting control. The minority shares in Pacific were publicly held by over 38,000 stockholders, including petitioners.

Pacific operated within the States of California, Oregon, Washington and a part of Idaho. Between the end of World War II and the beginning of 1961, Pacific's telephone business experienced enormous growth and was expected to continue to expand at a rapid rate. Due to this growth and the size of the area served by Pacific, many of its activities were controlled locally within the various states in which it operated. Eventually a separate division was set up to operate almost autonomously [Tr. 305] in the States of Oregon, Washington and Idaho. It was then concluded that it would be preferable to disassociate completely the activities of that division from the operations of Pacific in California by a transfer of the entire business conducted in the three northern states to a new corporation to be followed by a distribution to the shareholders of Pacific of the stock of the new corporation. To accomplish this objective Pacific Northwest Bell Telephone Company ("Northwest") was organized as a Washington corporation on March 27, 1961, and as of July 1, 1961, Pacific transferred to it all of the assets pertaining to operations in the area to be served by the

new corporation. In return for the assets received, Northwest assumed some of the liabilities to which such assets were subject, issued to Pacific a promissory note payable on demand in the principal amount of $200,000,000, and issued to Pacific 30,450,000 shares of its $11 par value common stock having an aggregate par value of $334,-950,000.[3]

Since Pacific was then in need of additional capital to finance its own operations in California, the Plan to distribute the Northwest shares to Pacific's stockholders was devised in such manner that it would provide Pacific with such needed **[Tr. 306]** capital at the same time. This was accomplished by Pacific's issuing transferable short-term rights to its shareholders to buy the Northwest stock.[4] In order to receive a share of Northwest it was necessary to surrender six rights and to pay $16 in cash. Such Northwest stock was expected to have and did in fact have a fair market value substantially in excess of the $16 subscription price. The petitioners in both cases before us exercised their rights thus obtaining shares of Northwest having a fair market value considerably greater than the cash paid therefor; also, petitioners

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[3]Pacific had previously purchased for $110,000 in cash 10,000 shares of Northwest common stock at par, which the Government agrees was an integral part of the later transfer.

[4]Pacific thus disposed of some 57.3 percent of its Northwest stock in 1961 and the remainder in 1963. There is no dispute between the parties that the two offerings were component parts of a single plan and that they must be regarded together as resulting in the disposition of 100 percent of the Northwest stock in a single transaction.

The amount of stock (57.3 percent) covered by the first offering was determined in such manner that direct control of the new corporation (over 50 percent stock ownership) would pass immediately from Pacific to American.

Gordon had four remaining rights which they sold for $6.36. Two principal problems are thus presented for solution: (1) Whether petitioners in both cases realized dividend income to the extent that the Northwest stock had a fair market value in excess of the subscription price; and (2) what is the proper tax treatment of the cash received by the Gordons upon the sale of their remaining rights?

[Tr. 307] 1. *Exercise of rights.* There is no serious question that, apart from certain specific provisions of the 1954 Code, the exercise of rights by Pacific's stockholders in the circumstances of this case would result in their receiving taxable dividends equal to the excess of the value of the Northwest stock over the subscription price. So much is clear from such decisions as *Palmer v. Commissioner,* 302 U.S. 63, and *Choate v. Commissioner,* 129 F. 2d 684 (C.A. 2).[5] However, petitioners contend that there are provisions in the 1954 Code which preclude the treatment of the foregoing amounts as taxable dividends.

[5] The *Palmer* case has generally been regarded as based upon the theory that there may be a taxable dividend where the optioned stock is worth more than the subscription price at the time of the offering, and since the Northwest stock had a value substantially in excess of the subscription price at the time of issuance of the rights, there is not present here the condition for nontaxability that existed in the *Palmer* case itself. The scope of *Palmer* was considered at length in *Choate,* and, since the value of the Northwest stock on the dates of exercise of the rights herein was not in excess of its value on the date of issuance of the rights the problem which proved so troublesome in *Choate* is not before us. The Commissioner has charged petitioners with having received dividends only to the extent that the Northwest stock had a value on the date of exercise of the rights in excess of the subscription price, and such excess in turn was less than the corresponding excess as of the time of the offering.

They argue that the transaction was completely tax-free under Section 355, dealing with the distribution of stock and securities of a controlled corporation (so-called spin-off or divisive reorganization), or alternatively under Section 354, involving exchanges **[Tr. 308]** of stock and securities in certain reorganizations. As a further alternative, they take the position that if Sections 355 and 354 are inapplicable, then the distribution resulting from the receipt of Northwest stock by petitioners was a distribution in partial liquidation of Pacific under Section 346(b), resulting in the realization of capital gains as provided therein. Since we have reached the conclusion that Section 355 is applicable, we do not pass upon the alternative contentions.

Section 355 is captioned "DISTRIBUTION OF STOCK AND SECURITIES OF A CONTROLLED CORPORATION." Subject to various conditions and limitations spelled out therein,[6] it was intended **[Tr. 311]** to provide for nonrecognition of gain or loss in a so-called spin-off or divisive reorganization, whereby a corporation divests itself of one of its business enterprises through the me-

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[6]SEC. 355. DISTRIBUTION OF STOCK AND SECURITIES OF A CONTROLLED CORPORATION.

(a) Effect on Distributees.—

(1) General Rule.—If—

(A) a corporation (referred to in this section as the "distributing corporation")—

(i) distributes to a shareholder, with respect to its stock, or

(ii) distributes to a security holder, in exchange for its securities,

solely stock or securities of a corporation (referred to in this section as "controlled corporation") which it controls immediately before the distribution,

(B) the transaction was not used principally as a device for the distribution of the earnings and profits of the

dium of distributing to its stockholders the stock of a subsidiary in which such business is being carried on at the time of distribution. See Sen. Rep. No. 1622, 83d Cong., 2d Sess., pp. 266-268. It is undisputed that the telephone and communications operations conducted in

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distributing corporation or the controlled corporation or both (but the mere fact that subsequent to the distribution stock or securities in one or more of such corporations are sold or exchanged by all or some of the distributees (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device),

(C) the requirements of subsection (b) (relating to active businesses) are satisfied, and

(D) as part of the distribution, the distributing corporation distributes—

(i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or

(ii) an amount of stock in the controlled corporation constituting control within the meaning of section 368(c), and it is established to the satisfaction of the Secretary or his delegate that the retention by the distributing corporation of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax,

then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder or security holder on the receipt of such stock or securities.

* * * * * *

(3) Limitation.—Paragraph (1) shall not apply if—

(A) the principal amount of the securities in the controlled corporation which are received exceeds the principal amount of the securities which are surrendered in connection with such distribution, or

(B) securities in the controlled corporation are received and no securities are surrendered in connection with such distribution.

For purposes of this section (other than paragraph (1)(D) of this subsection) and so much of section 356 as relates to this section, stock of a controlled corporation acquired by the distributing corporation by reason of any transaction which occurs within 5 years of the distribution of such stock and in which gain or loss was recognized in whole or in part, shall not be

Oregon, Washington and Idaho constituted a separate business; and it is also undisputed that if Pacific had transferred that business to Northwest solely for stock of the latter (here Pacific received a $200,000,000 note in addition to stock), and if Pacific had then distributed

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treated as stock of such controlled corporation, but as other property.

* * * * * *

(b) Requirements as to Active Business.—

(1) In General.—Subsection (a) shall apply only if either—

(A) the distributing corporation, and the controlled corporation (or, if stock of more than one controlled corporation is distributed, each of such corporations), is engaged immediately after the distribution in the active conduct of a trade or business, or

(B) immediately before the distribution, the distributing corporation had no assets other than stock or securities in the controlled corporations and each of the controlled corporations is engaged immediately after the distribution in the active conduct of a trade or business.

(2) Definition.—For purposes of paragraph (1), a corporation shall be treated as engaged in the active conduct of a trade or business if and only if—

(A) it is engaged in the active conduct of a trade or business, or substantially all of its assets consist of stock and securities of a corporation controlled by it (immediately after the distribution) which is so engaged,

(B) such trade or business has been actively conducted throughout the 5-year period ending on the date of the distribution,

(C) such trade or business was not acquired within the period described in subparagraph (B) in a transaction in which gain or loss was recognized in whole or in part, and

(D) control of a corporation which (at the time of acquisition of control) was conducting such trade or business—

(i) was not acquired directly (or through one or more corporations) by another corporation within the period described in subparagraph (B), or

(ii) was so acquired by another corporation within such period, but such control was so acquired only by reason of transactions in which gain or loss was not recognized in whole or in part, or only by reason of such transactions combined with acquisitions before the beginning of such period.

the Northwest stock without consideration to its own stockholders (rather than through the medium of stock rights), the distribution **[Tr. 312]** would have qualified as a nonrecognizable spin-off. Such distribution would have been what petitioners properly characterize as a classic case of a tax-free divisive reorganization. And we hold that neither the use of stock rights nor the presence of the note requires a different result under Section 355.

Subject to the conditions spelled out in the four subparagraphs (A) through (D), Section 355(a)(1) provides in substance that where a corporation (the "distributing corporation") distributes to its shareholders stock of a corporation controlled by it no gain or loss shall be recognized by the distributees. Cf. *W.E. Gabriel Fabrication Co.,* 42 T.C. 545, 551. The principal controversy herein relates to subparagraphs (A) and (C). Subparagraph (B) is not involved at all since there is no contention that the transaction was used as a "device for the distribution of the earnings and profits" of either Pacific or Northwest. And subparagraph (D) is involved herein only in a manner closely related to subparagraph (A).

The conditions of subparagraph (A) appear in Section 355(a)(1) as follows:

SEC. 355. DISTRIBUTION OF STOCK AND SECURITIES OF A CONTROLLED CORPORATION.

(a) Effect on Distributees.—

(1) General Rule.—If—

(A) a corporation (referred to in this section as the "distributing corporation")—

(i) distributes to a shareholder, with respect to its stock, * * *

* * * * * * *

[Tr. 313] solely stock or securities of a corporation (referred to in this section as "controlled corporation") which it controls immediately before the distribution,

* * * * * * *

then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder or security holder on the receipt of such stock or securities.

As we understand the Government's position, it is that the conditions of (A) have not been satisfied since Pacific did not distribute the stock of Northwest but rather distributed rights to purchase the Northwest shares,[7] and that the stock of Northwest was in any event not distributed "with respect to its [Pacific's] stock". We think that these contentions are unsound.

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[7]It argues further at this point that such rights did not constitute "stock or securities" within Section 355(a)(1)(A). In view of our conclusion that the shares of Northwest rather than the rights were the subject of the distribution within the meaning of (a)(1)(A) it becomes unnecessary to resolve the controversy as to whether the rights themselves would qualify as "stock or securities".

The Government's position is based upon a highly technical and inhospitable reading of the statute that fails to give effect to the basic objective that Congress sought to achieve. This case concededly involves a spin-off. Pacific plainly divested itself of the business which it had conducted in the three northwest states. Had it distributed the Northwest stock directly to its stockholders without consideration there would clearly have been the type of divisive reorganization contemplated **[Tr. 314]** by the statute, at least as far as subparagraph (A) is concerned. And, in our view, the situation is not changed merely because that distribution was conditioned upon payment of $16 a share by the distributees. It was nonetheless a distribution of Northwest stock to these petitioners, stockholders in Pacific, made "with respect to" their ownership of stock in Pacific. If Congress had intended that a distribution of the Northwest stock be treated as tax-free when made without consideration, it is inconceivable that it could have intended the transaction to result in taxable income to the distributees where they *paid out* money in connection with receiving such stock. The stock of Northwest was literally "distributed" to petitioners, albeit for a consideration, and we hold that the statute should not be construed so as to depart from such literal meaning, where to do so would frustrate the legislative purpose.

The Government's argument revolves largely around the notion that the rights to subscribe were the subject of the distribution rather than the Northwest stock itself, and that the stock was obtained only as a result of exercising those rights. However, *Palmer v. Commissioner*,

302 U.S. 63,[8] makes it clear that **[Tr. 315]** issuance of the rights, even though they may be valuable, may not be considered as a distribution of corporate earnings and profits. If any income is to be charged to petitioners it must be regarded as stemming from the exercise of the rights, by obtaining the Northwest stock for a consideration less than its fair market value. But Section 355 was intended to permit the receipt of such stock without tax even where the recipient paid nothing therefor, and we think it would be a distortion of Congressional purpose to impute an intention to impose the tax where the recipient was required in effect to contribute to the capital of the distributing corporation as a condition to receiving the distributed stock. We conclude that the transaction before us was within the terms of Section 355(a)(1)(A), and we next consider whether the conditions of (a)(1)(C) have been met.

Subparagraph (C) is not self-contained, but incorporates other provisions by reference; it spells out as one of the conditions for nonrecognition in Section 355(a)(1) that:

> (C) the requirements of subsection (b) (relating to active businesses) are satisfied

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[8]There is no merit to the Government's contention that *Palmer* is no longer good law in this respect. There is no indication in the 1954 Code that Congress intended to disapprove any part of that decision, and it has been applied by the courts in cases arising thereunder. See *William H. Bateman*, 40 T.C. 408. The employee stock option cases, *Commissioner v. LoBue*, 351 U.S. 243, and *Commissioner v. Smith*, 324 U.S. 177, relied on by the Commissioner as authority overruling *Palmer*, do not discuss this aspect of that case at all, but rather cite *Palmer* with approval in other respects.

Thus, subparagraph (C) is really nothing more than the means whereby the provisions of subsection (b) are brought into play at this point.

[Tr. 316] Subsection (b) provides in part as follows:

(b) Requirements as to Active Business.—

(1) In General.—Subsection (a) shall apply only if either—

(A) the distributing corporation, and the controlled corporation * * * is engaged immediately after the distribution in the active conduct of a trade or business, or

* * * * * * *

(2) Definition.—For purposes of paragraph (1), a corporation shall be treated as engaged in the active conduct of a trade or business if and only if—

(A) it is engaged in the active conduct of a trade or business, or substantially all of its assets consist of stock and securities of a corporation controlled by it (immediately after the distribution) which is so engaged,

(B) such trade or business has been actively conducted throughout the 5-year period ending on the date of the distribution,

(C) such trade or business was not acquired within the period described in subparagraph (B) in a transaction in which gain or loss was recognized in whole or in part, and

* * * * * * *

There is no dispute that Pacific and Northwest were each engaged in the active conduct of a trade or business within (b)(1)(A), or that the requirements of (b)(2)(A) and (b)(2)(B) have been met. However, the Government

argues that there has been a failure in respect of Northwest to comply with (b)(2)(C), in that the transaction whereby Northwest acquired its business from Pacific was one "in which gain or loss was recognized in whole or in [Tr. 317] part". Petitioners vigorously deny that any gain or loss was recognized.

The purpose of these provisions was to prevent a tax-free distribution of a corporation's earnings and profits through the medium of a temporary purchase of a going business with liquid assets and then in effect distributing those assets to its stockholders. See Cohen, Silverman, Surrey, Tarleau and Warren, *The Internal Revenue Code of 1954: Corporate Distributions, Organizations, and Reorganizations,* 68 Harv. L. Rev. 393, 430. Plainly, no such circumstances were present here, since this case involves a bona fide separation of a business conducted for many years by Pacific. We turn then to the particular contentions urged by petitioners in support of their position that the gain on the transfer of assets by Pacific to Northwest was nonrecognizable. They rely upon two alternative grounds: (1) that as a result of the consolidated return filed in behalf of Pacific and the affiliated group, no gain or loss was in fact recognized; and (2) that in any event the transfer of the business by Pacific to Northwest was nonrecognizable under Section 351.[9]

[9] SEC. 351. TRANSFER TO CORPORATION CONTROLLED BY TRANSFEROR.

(a) General Rule.—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation. * * *

[Tr. 318] It is in connection with this second ground that the matter of the $200,000,000 note becomes pertinent, since the Government contends that Pacific's transfer to Northwest was not "solely in exchange for stock or securities" of Northwest, in view of the note as part of the consideration for the transfer. Petitioners, on the other hand, argue that the note is a security within the meaning of Section 351. We need not resolve this controversy, because, in our view, there was no recognizable gain or loss by reason of the consolidated return, and it therefore becomes unnecessary to consider the alternative ground.

As subsidiaries of American, Pacific and Northwest were included in the group of affiliated corporations for which a consolidated return was filed for 1961. Thus, the gain resulting from the transfer of assets from Pacific to Northwest which might otherwise have been subject to tax was eliminated in that consolidated return pursuant to regulations prescribed by the Commissioner under Section 1502. Those regulations provide as follows (Regulations 1.1502-31(b)(1)):

> (b) *Computations.* In the case of affiliated corporations which make, or are required to make, a consolidated return, and except as otherwise provided in the regulations under section 1502:
>
> (1) *Taxable income.* The taxable income of each corporation shall be computed in accordance with the provisions covering the determination of taxable income of separate corporations, except:
>
> [Tr. 319] (i) There shall be eliminated unrealized profits and losses in transactions between members of the affiliated group and dividend distributions

> from one member of the group to another member of the group (referred to in the regulations under section 1502 as intercompany transactions);

The Government does not dispute that the gain upon the transfer from Pacific to Northwest was properly relieved of tax in the consolidated return. It argues, however, that the regulations provide for the *elimination* of gain or loss whereas Sections 355(b)(2)(C) and 351 are phrased in terms of *nonrecognition* of gain or loss. It contends that the gain herein was "recognized" but "eliminated". We think that this distinction is spurious, and that the terms "elimination" and "nonrecognition" are intended to be synonymous in this context. Apart from the absence of any solid basis for the claimed distinction, a careful textual examination of the statute and regulations discloses that the word "eliminated" was used in the sense of "nonrecognition".

Under the regulations "unrealized profits and losses" arising out of intercompany transactions are to be "eliminated". Here, it is undisputed that the gain on the transfer from Pacific to Northwest was properly "eliminated", and therefore must have been an "unrealized" gain within the meaning of these provisions. Yet Section 1002 directs that, except as otherwise provided, the entire gain or loss on a sale or exchange of property determined under Section 1001 shall be "recognized". And Section 1001(a) states that the gain on sale of property **[Tr. 320]** "shall be the excess of the amount realized therefrom over the adjusted basis * * *". Thus, if no gain were "realized" within the meaning of the regulations so as to justify "elimination", no such gain was "recognized".

This result is confirmed by examining the consequences that would follow in respect of the basis of the transferred property. Section 1051, dealing with the basis of property acquired in an intercompany transaction, provides as follows:

> SEC. 1051. PROPERTY ACQUIRED DURING AFFILIATION.
>
> In the case of property acquired by a corporation, during a period of affiliation, from a corporation with which it was affiliated, the basis of such property, after such period of affiliation, shall be determined, in accordance with regulations prescribed by the Secretary or his delegate, without regard to inter-company transactions in respect of which gain or loss was not recognized. * * *

The basis of the property is thus to be determined "without regard to inter-company transactions in respect of which gain or loss was not recognized". However, if gain were "recognized" in such a transaction, the basis of the property in the hands of the transferee would be "increased in the amount of gain recognized to the transferor". Section 362.

Plainly, all of the foregoing provisions contemplate *nonrecognition* of gain or loss in intercompany transactions, with the result that the transferred property retains its basis in the hands of the transferee. If "elimination" meant something different from "nonrecognition", and if the Commissioner were **[Tr. 321]** correct here, then we would have the bizarre situation where the gain were "recognized" even though "eliminated" and the property transferred would acquire a stepped-up

basis even though no tax were paid on the gain. We can hardly imagine the Commissioner accepting any such result without a struggle. The real difficulty is due to his unsound position here. We hold that the gain "eliminated" in the consolidated return was not "recognized", with the consequence that the requirements of Section 355(b)(2)(C) have been met, thus complying with the condition of Section 355(a)(1)(C).

There remains finally for consideration whether the condition of Section 355(a)(1)(D) has been met. As already noted, subparagraph (D) is closely related to (A) as it is involved herein. It requires that—

> (D) as part of the distribution, the distributing corporation distributes—
>
> (i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or
>
> (ii) an amount of stock in the controlled corporation constituting control within the meaning of section 368(c), * * *

Certainly, Pacific disposed of every share of Northwest, retaining none whatever, thus satisfying the underlying objective **[Tr. 322]** of subparagraph (D).[10] The reason-

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[10]That objective has been satisfied by Pacific's parting with every share of Northwest. However, if it be thought necessary that such distribution be made to the stockholders of Pacific, the fact that some shares were transferred to purchasers of rights rather than to the stockholders is immaterial here. For, not only did the ultimate transferees take through the stockholders, but in any event the record discloses that the stock rights sold represented only a small percentage of the rights issued, and at least more than 80 percent of the shares, constituting control under Section 368(c), were in fact distributed to shareholders of Pacific, thus satisfying either part (i) or (ii) of subparagraph (D).

ing behind the Government's highly technical argument that Pacific did not "distribute" all the Northwest stock is basically the same as its position under (A), and rests on the notion that the issuance of the stock rights and the exercise thereof preclude a finding that Pacific had "distributed" all of the Northwest stock. We reject that position here in accordance with the conclusion that we reached in respect of the argument relating to (A).

2. *Sale of rights.* The remaining issue concerns the taxation of the proceeds received by petitioners Gordon from the sale of four of the rights issued to them. This sale took place on October 5, 1961, and the Gordons received $6.36 for the four rights or $1.59 each. In *Gibson v. Commissioner,* 133 F. 2d 308 (C.A. 2), the court held that a sale of rights results in "ordinary income" at least "to the extent of the spread between the market value of the stock at the time of the issuance of the option and the option price for the stock" (p. 309).

[Tr. 323] The value of the rights herein on the issuance date, September 29, 1961, was greater than $1.59 per right so that there is not presented here any problem comparable to that considered in *Choate v. Commissioner,* 129 F. 2d 684 (C.A. 2), where the market value of the optioned stock increased after the rights were issued.

In *Gibson,* the court determined that the petitioner there received an option to obtain a distribution, and through a sale of her rights she anticipated that distribution. The amount realized in anticipation of the distribution was required to be treated in the same manner as the distribution itself. Cf. *Helvering v. Horst,* 311 U.S. 112.

Petitioners accept this reasoning, but contend that since under Section 355 the distribution of stock in the present case is nontaxable and no gain would be recognized until a sale of the stock, the amounts realized from a sale of the rights should be taxed in the same manner as gains from sales of the stock, i.e., capital gains. This argument fails to take into account the nature of Section 355, which is a nonrecognition provision, and can be utilized only by those shareholders who come within its terms. Those shareholders who sold their rights did not **[Tr. 324]** come under Section 355 in respect of such rights,[11] and without Section 355 a distribution of the stock of another corporation would have resulted in the distribution of a dividend to the shareholders of the distributing corporation. The anticipation of such a distribution results in a realization of income which must similarly be treated as a dividend to which the dividends received credit applies. Cf. *Tobacco Products Export Corporation,* 21 T.C. 625.

Decision will be entered for the petitioners in Docket No. 949-63.

Decision will be entered under Rule 50 in Docket No. 3949-63.

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[11]The same would be true with respect to any other provisions, such as those in Section 354, upon which petitioners might rely as a ground for relieving them of the tax upon the exercise of the rights, even if we were to hold such provisions applicable in such circumstances, an issue that we found unnecessary to decide. See p. 257, *supra*.

[Tr. 329]

TAX COURT OF THE UNITED STATES

Docket No. 3949-63

IRVING GORDON and MARGARET GORDON, *Petitioners,* v. COMMISSIONER OF INTERNAL REVENUE, *Respondent.*	

DECISION

Pursuant to the opinion of the Court filed October 19, 1965, and the agreed computation of the tax liabilities filed by the parties; and incorporating herein the facts recited in the computation as the findings of the Court, it is

ORDERED and DECIDED: That there is an overpayment in income tax for the taxable year 1961 in the amount of $893.19, which amount was paid after the mailing of the notice of deficiency.

(Signed) ARNOLD RAUM
Judge.

Entered: Dec 15 1965

* * * *

It is hereby stipulated that the foregoing decision is in accordance with the opinion of the Court and the agreed computation of the parties, and that the Court may enter this decision, without prejudice to the right of either party to contest the correctness of the decision entered

herein, pursuant to the statute in such cases made and provided.

[Signatures omitted]

TAX COURT OF THE UNITED STATES

WASHINGTON

Docket No. 949-63

OSCAR E. BAAN and EVELYN K. BAAN, *Petitioners,* v. COMMISSIONER OF INTERNAL REVENUE, *Respondent.*	

DECISION

Pursuant to the determination of the Court, as set forth in its Findings of Fact and Opinion filed October 19, 1965, it is

ORDERED and DECIDED: That there is no deficiency in income tax for the year 1961.

Entered: Oct 20 1965

Arnold Raum
Judge.

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 214—September Term, 1966.

(Argued January 24, 1967 Decided July 26, 1967.)

Docket No. 30572

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

—v.—

IRVING GORDON and MARGARET GORDON,

Respondents.

IRVING GORDON and MARGARET GORDON,

Petitioners,

—v.—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Before:

MOORE and FRIENDLY, *Circuit Judges;*
BRYAN,* *District Judge.*

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* For the Southern District of New York, sitting by designation.

Petition for review of a decision of the Tax Court of the United States, Raum, *Judge*. The Commissioner of Internal Revenue petitions this Court to review a decision of the Tax Court that a distribution of stock to the taxpayers was governed by Section 355 of the Internal Revenue Code of 1954. Taxpayer seeks review of a decision that the sale of stock rights constituted dividend income. Opinion below reported at 45 T. C. 71. Affirmed in part and reversed in part.

MARTIN T. GOLDBLUM, Washington, D. C. (Mitchell Rogovin, Assistant Attorney General; Lee A. Jackson, Gilbert E. Andrews, on the brief), *for petitioner-respondent.*

HARRY R. HORROW, San Francisco, California (Stephen J. Martin, Pillsbury, Madison & Sutro, San Francisco, California, on the brief), *for respondents-petitioners.*

MOORE, *Circuit Judge:*

The taxpayers, Irving and Margaret Gordon (husband and wife) in 1961 owned 1,540 shares of Pacific Telephone and Telegraph Company (Pacific) common stock. Their stock certificate represented a fractional part, in theory at least, of all the assets of this company. Although collectively the stockholders owned these assets, the corporate form was not within the control of the individual stockholder but, for all practical purposes, in the control of the company's management. Therefore, when Pacific decided to have its assets held by two corporations instead of one, the position of the Gordons remained unchanged. They merely needed to have another piece of paper to evidence

their same fractional asset ownership. This, in substance, Pacific supplied. However, as a result of the transaction, the Commissioner of Internal Revenue (the Commissioner) has assessed an income tax against the Gordons who properly ask, probably in some wonderment, how this corporate change of asset ownership brought income to them and, if so, where is it?

Before considering the facts, which are not in dispute, the trite statement that an income tax should be a tax on income may serve as a beacon. All too frequently, Commissioners and courts launch into an anlysis of tax sections, subsections, paragraphs and subparagraphs which practically exhaust the alphabet and Roman and Arabic numbers. In this intellectual exercise, the taxpayer often is only an incidental (though necessary) figure. Therefore, this review will be based on the principle that the ultimate question to be answered is: did the Gordons receive taxable income within the meaning of the Code because of their ownership of a Pacific stock certificate? It must be presumed that in enacting all the sections of the Code, relating to corporate changes, Congress adhered to the fundamental purpose of taxing income. The Tax Court, 45 T. C. 71, has held that they did not as to 1,536 shares; the Commissioner appeals. As to four (4) stock rights sold, the Tax Court held that income resulted and the Gordons appeal. We affirm the Tax Court as to the Commissioner's appeal and reverse as to the Gordons' (taxpayers') appeal.

The principal question presented by this petition to review the decision of the Tax Court is whether the nonrecognition provisions of Section 355 of the Internal Revenue Code of 1954 can be applied to a spin-off by Pacific of a part of its assets. Pacific is a subsidiary of the American Telephone and Telegraph Company (AT&T) which at all times owned over 80% of Pacific's common stock. Prior to

July 1, 1961, Pacific provided the telephone services for California, Oregon, Washington and Idaho.[1] This is a rapidly growing area of the country and for purely business reasons, Pacific decided to divide the corporation. To this end a new corporation, Pacific Northwest Bell Telephone Company (Northwest), was formed to take over the non-California business of Pacific. Pacific's management studied a variety of methods by which to effect the division, one of which was a conventional spin-off which clearly would have qualified under Section 355.[2] This

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1 Pacific also provided telephone service in Nevada through a wholly-owned subsidiary which was not included in the spin-off here considered.

2 Section 355 of the Internal Revenue Code of 1954 reads as follows:

"Sec. 355. Distribution of Stock and Securities of a Controlled Corporation.

(a) Effect on Distributees.

(1) General Rule.—If—

(A) a corporation (referred to in this section as the 'distributing corporation')—

(i) distributes to a shareholder, with respect to its stock, or

(ii) distributes to a security holder, in exchange for its securities, solely stock or securities of a corporation (referred to in this section as 'controlled corporation') which it controls immediately before the distribution,

(B) the transaction was not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both (but the mere fact that subsequent to the distribution stock or securities in one or more of such corporations are sold or exchanged by all or some of the distributees (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device),

(C) the requirements of subsection (b) (relating to active businesses) are satisfied, and

(D) as part of the distribution, the distributing corporation distributes—

(i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or

method was rejected partly because of state law obstacles and, presumably, partly because the AT&T family filed a consolidated tax return which eliminated intercorporate dividends and thus qualification under Section 355 was not of great importance to the corporate management. It is,

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(ii) an amount of stock in the controlled corporation constituting control within the meaning of section 368(c), and it is established to the satisfaction of the Secretary or his delegate that the retention by the distributing corporation of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax,

then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder or security holder on the receipt of such stock or securities.

(2) Non pro rata distributions, etc.—Paragraph (1) shall be applied without regard to the following:

(A) whether or not the distribution is pro rata with respect to all of the shareholders of the distributing corporation,

(B) whether or not the shareholder surrenders stock in the distributing corporation, and

(C) whether or not the distribution is in pursuance of a plan of reorganization (within the meaning of section 368(a)(1)(D)).

(3) Limitation.—Paragraph (1) shall not apply if—

(A) the principal amount of the securities in the controlled corporation which are received exceeds the principal amount of the securities which are surrendered in connection with such distribution, or

(B) securities in the controlled corporation are received and no securities are surrendered in connection with such distribution.

For purposes of this section (other than paragraph (1)(D) of this subsection) and so much of section 356 as relates to this section, stock of a controlled corporation acquired by the distributing corporation by reason of any transaction which occurs within 5 years of the distribution of such stock and in which gain or loss was recognized in whole or in part, shall not be treated as stock of such controlled corporation, but as other property.

(4) Cross Reference.—

For treatment of the distribution if any property is received which is not permitted to be received under this subsection (in-

however, vital to the minority Pacific stockholders and to the taxpayers Gordon, who owned 1,540 shares of Pacific common stock. It is their position that regardless of what the Pacific management intended, the distribution should be given the preferred tax treatment provided by Section 355.

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cluding an excess principal amount of securities received over securities surrendered), see section 356.

(b) Requirements as to Active Business.—

(1) In General.—Subsection (a) shall apply only if either—

(A) the distributing corporation, and the controlled corporation (or, if stock of more than one controlled corporation is distributed, each of such corporations), is engaged immediately after the distribution in the active conduct of a trade or business, or

(B) immediately before the distribution, the distributing corporation had no assets other than stock or securities in the controlled corporations and each of the controlled corporations is engaged immediately after the distribution in the active conduct of a trade or business.

(2) Definition.—For purposes of paragraph (1), a corporation shall be treated as engaged in the active conduct of a trade or business if and only if—

(A) it is engaged in the active conduct of a trade or business, or substantially all of its assets consist of stock and securities of a corporation controlled by it (immediately after the distribution) which is so engaged,

(B) such trade or business has been actively conducted throughout the 5-year period ending on the date of the distribution,

(C) such trade or business was not acquired within the period described in subparagraph (B) in a transaction in which gain or loss was recognized in whole or in part, and

(D) control of a corporation which (at the time of acquisition of control) was conducting such trade or business—

(i) was not acquired directly (or through one or more corporations) by another corporation within the period described in subparagraph (B), or

(ii) was so acquired by another corporation within such period, but such control was so acquired only by reason of transactions in which gain or loss was not recognized in whole or in part, or only by reason of such transactions combined with acquisitions before the beginning of such period."

The plan ultimately agreed upon required Pacific to transfer to Northwest all of the non-California assets and liabilities plus $110,000 in cash in return for the issuance of 30,460,000 shares of Northwest common stock and an interest bearing demand note in the amount of $200,000,000. The result of these arrangements was to give Northwest a capital structure similar to that of Pacific. On June 30, 1961, Pacific ceased all non-California business. This Plan, which had been accepted by the Pacific shareholders in March of 1961, further required Pacific to offer to its shareholders the right to purchase *all* of the Northwest stock held by Pacific on a pro rata basis. It was left to the sole discretion of the Pacific management, however, to determine the number of offerings of Northwest stock to the Pacific shareholders and the price at which the stock would be made available. The Plan, nevertheless, made it clear that these decisions were to be made in response to the capital requirements of Pacific and it was anticipated that all of the Northwest stock would be distributed within three years. On September 20, 1961, Pacific issued one transferable stock right for each outstanding share of Pacific stock. Six such rights plus a payment of $16 were required to subscribe to one share of Northwest stock, which at this time had a fair market value of $26 per share. This initial distribution involved approximately 57% of the Northwest stock held by Pacific, an amount selected in order to pass control of Northwest to AT&T immediately following the first stage of the distribution. A second and final offering, the terms of which required eight rights plus $16 to obtain one share of Northwest stock, was made on June 12, 1963, of the remaining 43% of the stock.

Pacific adopted this more complex mechanism for distribution to enable it to satisfy simultaneously its very large requirements for additional capital to finance expan-

sion. In each annual period prior to 1961, Pacific had been required to issue common stock or debentures in an average amount of nearly 200 million dollars per year. In the three years following 1961, however, these capital requirements were satisfied through the funds received from its distribution of Northwest stock and no common stock or debentures were issued.

In response to a request by Pacific, the Commissioner issued a ruling letter prior to the first offering which concluded that the sale of the rights would produce ordinary income and that their exercise would constitute a dividend under Section 301. He further stated that Section 355 would not be applicable.

This appeal involves only the tax year of 1961. The taxpayers exercised 1,536 of the 1,540 rights they received that year. On their income tax return, the taxpayers took the position that this aspect of the transaction was not subject to tax and therefore reported no gain or loss. The other four rights were sold for a total amount of $6.36, which was reported as a capital gain. On July 19, 1963, the Commissioner assessed a deficiency of $895.10 based on these transactions.

I.

It is not disputed that the Pacific-Northwest corporate division fulfilled a valid business purpose. Nor is it disputed that the method selected by Pacific to accomplish this division was dictated by valid business reasons. In fact, it does not appear to be disputed that there was no possibility under this transaction for turning ordinary income into capital gains—the evil which Section 355 was designed to prevent. Rather, the government contends that in a number of technical respects, the requirements of that Section were not met and that, therefore, the dis-

tribution of Northwest stock must be treated as a dividend. While the government raises a number of purely technical questions to which we shall shortly turn, the truly decisive question before this Court is how Section 355 shall be construed. The taxpayers argue that Section 355 is the embodiment of a Congressional decision that corporate divisions are desirable as a matter of public policy and should not be impeded by tax considerations. Congress recognized, of course, that corporate divisions are a perfect vehicle for bail-outs of earnings and profits and, therefore, hedged in the use of Section 355 with a number of conditions which must be met. But when the division presents no opportunity for a bail-out, these conditions should not be so construed as to frustrate the basic Congressional purpose. The Commissioner, for his part, argues that Section 355 is merely a tax concession granted by Congress to permit certain narrowly defined transactions. He concludes that, as with all such privileges, the statute is to be narrowly construed.

In evaluating the jurisprudential philosophy of the government, we are not required to limit our search to the instant case in which it serves the Commissioner's purpose to argue for a narrow construction. Initially, we note the long line of cases holding that mere compliance with the reorganization sections does not ensure a tax-free exchange if there is lacking a business purpose or, perhaps, a continuity of interest in the transaction. See, e.g., *Gregory* v. *Helvering,* 293 U. S. 465 (1935), *Bazley* v. *Commissioner,* 331 U. S. 737 (1947). While, obviously, the converse of this proposition is not true, these cases properly stand for the proposition that in determining tax results, the courts do not merely look to the literal language of the statute but also view the business transaction as a whole in conjunction with the underlying purpose of the

taxing statute. We are not aware of any rule of law that preserves such a salutary tenet of construction for the exclusive benefit of the Commissioner. See *Helvering* v. *Alabama Asphaltic Limestone Co.,* 315 U.S. 179 (1942).[3]

Furthermore, we note that the Commissioner has not always taken such a constricted view of the reorganization sections. When it serves his purpose, the Commissioner has argued that when a reorganization has in fact occurred, it should be taxed under the reorganization sections of the Code even though the strict requirements of the statute have not been met. See, e.g., *Gallagher* v. *Commissioner,* 39 T. C. 144 (1962); *Berghash* v. *Commissioner,* 43 T. C. 743 (1965), *aff'd* 361 F. 2d 257 (2 Cir. 1966).

While we think it beyond dispute that the courts are permitted a certain flexibility in applying the Code, it should be added that cases in which the courts must stray from the literal language of the Code in order to achieve its underlying objectives will not be frequent. Conversely, however, undermining the general purposes of the Code through an overly literal application of each of its technical provisions cannot be justified. Here it is evident that the taxpayers' investment remained in corporate solution

3 In sustaining the contention of the taxpayer that a reorganization had occurred, the Court stated:

> "Some contention, however, is made that this transaction did not meet the statutory standard because the properties acquired by the new corporation belonged at that time to the committee and not to the old corporation. That is true. Yet, the separate steps were integrated parts of a single scheme. Transitory phases of an arrangement frequently are disregarded under these sections of the revenue acts where they add nothing of substance to the completed affair. *Gregory v. Helvering,* 293 U. S. 465; *Helvering v. Bashford,* 302 U. S. 454. Here they were no more than intermediate procedural devices utilized to enable the new corporation to acquire all the assets of the old one pursuant to a single reorganization plan." 315 U. S. at 184-85.

(aside from the $6.36) and merely changed its form. The only additional factor was the payment of $16 per share which was in reality tantamount to a contribution to capital and that, of course, is no occasion for the imposition of a tax. Nor was there any opportunity for the taxpayers to use this transaction for a bail-out of earnings and profits. On the other hand, if the Commissioner prevails, taxpayers' equity investment will be turned into ordinary income.

Wholly aside from these considerations of a general nature, an examination of the specific objections made by the Commissioner reveals that at the maximum, this division strayed from the literal terms of Section 355 in only very minor respects.

A. *"Distributes . . . with respect to its stock."*

From the taxpayers' point of view, they found themselves holding two pieces of paper, a certificate for 1,540 shares of Pacific, and a certificate for 1,540 rights, which when exercised, together represented their ownership in Pacific's assets, including a $16 capital contribution, certainly not an income-producing act. They were neither richer nor poorer. Neither the receipt of the rights certificate and its exercise nor the capital contribution produced any income to them. The Tax Court quite properly observed that

> "If Congress had intended that a distribution of the Northwest stock be treated as tax-free when made without consideration, it is inconceivable that it could have intended the transaction to result in taxable income to the distributees where they *paid out* money in connection with receiving such stock." (Emphasis in original.) 45 T. C. 71.

Subsection (a)(1)(A)(i) requires that the stock of Northwest be distributed by Pacific with respect to the Pacific stock. The Commissioner argues that in fact Pacific distributed only stock rights with respect to its stock and that the Northwest stock was exchanged for six rights, which could have been purchased through the market by anyone and $16 and, thus, qualification under Section 355 is barred because a distribution of stock rights does not satisfy the statute. We think the result contended for by the Commissioner is precluded by *Palmer* v. *Commissioner,* 302 U. S. 63 (1937) and *Choate* v. *Commissioner,* 129 F. 2d 684 (2 Cir. 1942). Normally, the distribution of a stock right has no tax consequences because there is no distribution of corporate property until the right is exercised.[4] A sale or exchange of a stock right prior to exercise results in a tax only because it is an anticipation of gain from an exercise. It follows in this case that it is the actual distribution of the Northwest stock upon the exercise of the rights that is the relevant event and the use of the stock rights as a mere mechanism to accomplish this result should be disregarded. Compare *Kimbell-Diamond Milling Co.* v. *Commissioner,* 14 T. C. 74 (1950), *aff'd,* 187 F. 2d 718 (5 Cir. 1951); *Heller* v. *Commissioner,* 2 T. C. 371 (1943), *aff'd,* 147 F. 2d 376 (9 Cir. 1945).

Secondly, the Commissioner argues that the phrase "distribution . . . with respect to its stock" is a term of art that excludes the use of a cash consideration such as the $16 required here. He cites no authority for this proposition and we are aware of none. It is perfectly obvious that the Code does not contemplate the receipt of cash by a corporation in connection with a distribution with

4 Possible exceptions such as Section 305(b) have no application to the instant transaction.

respect to its stock in the sense that some specific section of the Code spells out the tax result. See Sections 311(a) and 312(d). But it scarcely follows that the Code prohibits the receipt of cash or that if the instant transaction is classified as falling within Section 355, the tax consequences cannot be determined. The only additional factor present is the payment of the $16 and that can be treated very simply as a contribution to capital by a shareholder. However, this question is not before us.[5]

The ultimate question before us is whether, when a reorganization is coupled with another transaction, these two transactions can, or should, be re-separated for federal income tax purposes. When it suits the Commissioner's convenience, he has so argued. See, *e.g.,* Rev. Rul. 61-156, 1961-2 C. B. 62; Regulations 1.301-1(e) and 1.331-1(c). And if the Code is to conform as closely as possible to economic reality, such a division should be performed when necessary. Of course, if the coupling itself is promotive of the evils which the taxing statute was designed to prevent, a separation for tax purposes should not be made for then the taxpayers would have obtained the best of all possible results to the prejudice of the fisc. Here the Tax Court concluded that no conceivable purpose would be served by denying tax-relief when the taxpayer paid out cash while such relief was granted absent this expense. The Commissioner answers the Tax Court by arguing that the use of transferable stock rights plus the $16 requirement "predictably will diminish the continuity of ownership." Thus the Commissioner invokes the judicial gloss on the reorganization sections that, with some exceptions, continuity

5 Although Pacific appears to have treated the cash obtained from the minority stockholders as gain from the sale of property, that is no bar to these taxpayers.

of interest must be maintained. The short answer to this argument is that it was. The doctrine of continuity of interest has never to our knowledge been used to void a reorganization on the ground that some shareholders might have sold their stock. Indeed, such a rule would void each and every attempted reorganization for with rare exceptions, stock can always be sold as Congress expressly permitted in Section 355(a)(1)(B). Rather, this limitation is applied to the actual result of a transaction: was a continuity of interest in fact maintained? Here over 95% of the shareholders in Pacific before 1961 exercised their rights and became shareholders in Northwest. Further, AT&T itself owned over 80% of the Pacific stock and after the division owned over 80% of both Pacific and Northwest. The doctrine of continuity of interest asks no more.[6]

B. *"Transaction in which gain or loss was recognized."*

The Commissioner further takes the position that qualification under Section 355 is barred by the requirement of Section 355(b)(2)(C) that the trade or business which is being actively conducted by either the controlled or the distributing corporation was not acquired in a transaction in which gain or loss was recognized. Taxpayers argue and the Tax Court agreed that because any gain or loss on the intercorporate transaction was eliminated on the consolidated tax return of these affiliated corporations, this condition of the Section was satisfied. Analysis of the purposes

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6 In *Commissioner* v. *Baan*, —— F. 2d —— (9 Cir. 1967), which arose out of the same corporate division and was decided by the Tax Court with the instant case, it was held that the requirements of Section 355 had not been met. One of the principal grounds of that decision was that while the mere use of stock rights may not preclude a tax-free division, the added condition of a $16 payment barred the application of Section 355 because of the danger that a continuity of interest would not be maintained.

underlying subsections (b)(2)(C) and (D) prohibits acceptance of this conclusion because the happenstance of affiliation does not remove the danger of purchasing a corporation for the purpose of distributing its stock as a dividend while avoiding the tax on dividends. However, this same analysis of the statute indicates clearly, we think, that 355(b)(2)(C) has no application to this case. The theory underlying 355(b), the active business requirement, is the prevention of the temporary investment of liquid assets in a new business in preparation for a 355(a) division. The primary danger envisioned by the draftsmen of this Section was the creation of the new business and the safeguard was the five-year provision. The reasoning is that if the new business must be operated for at least five years, there will be little incentive to use this device for tax avoidance purposes. The second danger was that instead of creating a new business, the corporation would purchase one which had been in existence for over five years and then distribute its stock in place of a dividend. To safeguard against this possibility, subsections (b)(2)(C) and (D) prohibit acquisition of a trade or business, or of a corporation, in a transaction in which gain or loss was recognized. In our case no new business, no new assets and no new corporation was acquired at all. No liquid assets were temporarily invested nor, in fact, was there any temporary investment. Consequently, the application of these sections to the instant transaction would serve no purpose at all. We think that the draftsmen of Section 355 intended these subsections to apply only to the bringing of new assets within the combined corporate shells of the distributing and the controlled corporations. Therefore, it is irrelevant in this case whether gain was recognized on the intercorporate transfer.

C. *Single Distribution.*

Finally, the Commissioner argues that there is an implied requirement in Section 355 that the distribution of stock take place in a single offering and since Pacific utilized two offerings separated by almost two years, the statutory requirement has not been met. It is conceded that there is no direct authority for this proposition but the Commissioner argues that such a result is demanded by the scheme of Section 355. In particular, he refers to subsection (a)(1)(D) which reads as follows:

> (D) as part of the distribution, the distributing corporation distributes—
>
> (i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or
>
> (ii) an amount of stock in the controlled corporation constituting control within the meaning of section 368(c), and it is established to the satisfaction of the Secretary or his delegate that the retention by the distributing corporation of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax,
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> * * * * *

On its face, this subsection is simply the embodiment of the Congressional decision that only complete, and not partial, divisions were to receive tax-free status and its purpose seems limited to establishing the amount of stock which must be distributed for qualification under Section 355. Both subdivisions require that the distributing corporation distribute an amount of stock in the controlled

corporation constituting control. Subdivision (D)(i) imposes the additional requirement that the distributing corporation distribute all of the stock held "immediately before" the distribution to its shareholders, even if that amount is less than all of the outstanding stock. The quoted language in no way requires a single distribution but is merely the means used to permit distribution of less than all of the outstanding stock in the controlled corporation. Alternatively, the corporation may proceed under (D)(ii) which permits retention of stock to a limited degree. Permitting retention at all is a departure from prior law and from the Congressional policy of complete division at the corporate level. To prevent abuse, Congress added to this subdivision a requirement that the taxpayer affirmatively demonstrate the absence of tax avoidance objectives instead of requiring the Commissioner to move under subsection (a)(1)(B). Here again, the fact that Congress permitted limited retention after the completion of the distribution cannot be said to imply that the distribution must have but a single phase. Thus there is nothing on the face of this subsection that relates to the number of transactions, or their timing, which may be contained in a distribution. These matters are entirely governed by the more flexible "device" clause of Section 355(a)(1)(B) which is fully adequate for this purpose and which clearly is no bar to the qualification of this corporate division. As there is no dispute that in both the original plan and in the fact a complete division occurred, applying the statute in this, the most obvious, manner and giving its words their everyday import compel the conclusion that subsection (a)(1)(D) was satisfied.

The Commissioner, however, contends that the requirements of subsection (a)(1)(D) "undoubtedly" were designed to prevent periodic distributions of stock in the

controlled corporation as a substitute for dividends. The only authority for this proposition is Professor Bittker who, in discussing the requirement of explaining retention to the Secretary, "presumes" this purpose. But Professor Bittker was not addressing himself to the question of a single distribution and the Commissioner omits to cite his further observation in the same paragraph that such an abuse would clearly be prohibited by subsection 355(a)(1)(B), the "device" clause, and thus if that is the purpose of the subsection, it is redundant. He further notes that there does not appear to be any necessity for the provision in any event. Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders 479 (2 Ed. 1966). Another commentator states that the requirement of subsection (a)(1)(D) "is designed to differentiate between genuine separations and incidental distributions of a controlled corporation's stock which take the place of current cash dividends." Surrey & Warren, Federal Income Taxation 1640 (1962). The Commissioner does not suggest that the instant transaction was not a genuine division nor could it conceivably be considered a substitute for a current dividend.

Whether a corporation has retained stock or distributed it is simply a question of the point in time that the manipulation is examined. The Commissioner argues that this point is immediately after the first transaction and that subsection (a)(1)(D)(ii) prohibits "retaining" over 20% of the stock after this point. The taxpayers argue that the time is after the culmination of the plan of distribution and that subsection (a)(1)(D)(ii) only prohibits an indefinite retention.[7] On its face Section 355 gives little

7 While the Plan adopted by Pacific theoretically might have permitted this, the surrounding facts make it certain, as found below, that long-term retention was never intended and, and course, was not

guidance but we do know that neither of the purposes suggested for subsection (a)(1)(D) will be defeated by permitting more than one distribution and that the construction of that provision for which the Commissioner argues does not fit easily within its language. But an adequate restriction is already provided by subsection (a)(1)(B).

Further, the incongruity of the result urged by the Commissioner when viewed against other provisions of the Code creates considerable doubt that Congress would intentionally require a single distribution. In 1961 Pacific was the eighth largest non-financial company in the United States and had over 38,000 shareholders. The reorganization resulted in a distribution of over 30 million shares of Northwest stock and raised for Pacific nearly one-half billion dollars. A requirement that such a transaction occur on a single day would be staggering. As far as this Court is aware, none of the other reorganization sections impose such a requirement, aside from the highly limited scope of *Bausch & Lomb Optical Co.* v. *Commissioner*, 276 F. 2d 75 (2 Cir. 1959), which is not relevant here. Regulations 1.368-2(c); Rev. Rul. 58-93, 1958-1 C. B. 188. See also Sections 332(b) and 337(a).

As it is fairly apparent that neither the Code nor the Regulations require, at least by their terms, a single distribution, such a requirement cannot be read into the Code, at least without a substantial reason. A fair reading of the Commissioner's brief indicates that he fears two problems from the result reached below. First, he suggests the danger of periodic distributions as a substitute for dividends and the tax avoidance that this would permit. But

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the fact. In the future, it would be preferable that such plans set out the timetable of distribution more precisely, as undoubtedly the Commissioner will require.

as we have noted, it is not clear that there are tax avoidance possibilities in such a scheme so long as the active business requirements are met; if they could be shown to exist, the "device" clause would prohibit any bail-out.

Second, the Commissioner points to a number of administrative difficulties inherent in permitting more than a single distribution such as leaving open the tax result for several years, the problem of defining the "date of distribution," and the difficulty in ascertaining whether there was control "immediately before" the distribution.[8] But the facts of this case can hardly be said to create the insurmountable administrative difficulties which the Commissioner has paraded before us in his brief. Here only two transactions occurred covering a maximum of three tax years. In fact, the deficiency notice in this case was not sent until July of 1963, two months after the second distribution was authorized. The Commissioner attacks the Tax Court by asserting that its opinion would permit ten distributions of 10% of the Northwest stock, an assertion most doubtful in itself for it overlooks the impact of subsection (a)(1)(B). But that is not our case and it can scarcely be contested that the Code imposes a tax on facts, not expectations. Perhaps the enormity of the administrative difficulties may be measured in part by the failure of the Commissioner to raise the single distribution point in the Tax Court.[9]

8 The fact that the two transactions which we hold constituted a single distribution occurred in different tax years is of no significance. Had the transactions occurred in January and December of 1961, we would be faced with the same questions as this case presents. The Commissioner makes no point of the fact that two tax years are involved, nor could be. See *Pridemark, Inc.* v. *Commissioner*, 345 F. 2d 34 (4 Cir. 1965).

9 In *Commissioner* v. *Baan, supra,* the Ninth Circuit alternatively held that while a single distribution was not required by subsection (a)(1)(D), because of the difficulties in administration, "such distri-

Conceding that some administrative problems will arise from our decision, they hardly provide a justification for denying tax-free reorganization status to a legitimate spin-off that entails none of the tax avoidance features that Section 355 was designed to prevent. In any event, we think it is the task of the Commissioner to resolve these difficulties, not the courts'. Nothing in our opinion prevents the Commissioner from drafting reasonable Regulations limiting the time period within which the entire distribution must be made, or the number of transactions which may be involved, or specifying what advance notice must be provided the Service, or defining the statutory language quoted above. But we are not prepared to apply retrospectively restrictions directed at evils which this case does not present.

The decision of the Tax Court on the Commissioner's petition is affirmed.

II.

Four of the stock rights issued by Pacific were sold by taxpayers for a total amount of $6.36. The Tax Court determined that aside from the effect of Section 355, this distribution by Pacific would be taxable as a dividend. The Court further held that Section 355 could have no application until there had actually been a distribution of stock and, thus, where the rights were disposed of prior to exercise, Section 355 had no application. Such an asymmetrical approach to Section 355 is untenable.

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butions must not extend over any greater period of time than is reasonably necessary considering the practical problems involved in completing such distributions.'' While this approach effectively compromises the harshness of the Commissioner's argument, the statute contains no such requirement.

It is well settled that the exercise of a stock right may result in dividend income if the fair market value of the acquired stock exceeds the option price. *Palmer* v. *Commissioner,* 302 U. S. 63 (1937), *Choate* v. *Commissioner,* 129 F. 2d 684 (2 Cir. 1942). And since the sale of a right may be an anticipatory realization of dividend income, gain on the sale is similarly taxed at ordinary income rates. *Helvering* v. *Horst,* 311 U. S. 112 (1940), *Gibson* v. *Commissioner,* 133 F. 2d 308 (2 Cir. 1943). However, in a transaction to which Section 355 applies, the distribution of stock by a corporation does not result in a dividend even though the distribution was accomplished by the use of stock rights and the option price was less than the fair market value of the acquired stock. The assumption of such cases as *Palmer* and *Gibson* is that a distribution of corporate earnings results from the existence of a "spread." Section 355, on the other hand, is a statutory device for determining that a distribution of capital, rather than of earnings, has occurred and therefore the assumption of those cases is inapplicable. The reasoning of *Gibson,* however, that the sale of a stock right should be taxed the same as an exercise is controlling.' Similar reasoning exists in Code Section 1234(a). And see *Rank* v. *United States,* 345 F. 2d 337 (5 Cir. 1965). Since the gain on an exercise of these rights, although deferred until the sale of the stock, would be capital, we hold that the sale of the rights similarly gave rise to capital gains. The error of the Tax Court was in forgetting that it is not the individual shares of stock received by these taxpayers that qualify under Section 355 but the entire distribution by Pacific.

The decision of the Tax Court on the taxpayers' petition is reversed.

Friendly, *Circuit Judge* (dissenting):

If in 1962 a revenue agent had reviewed the Gordons' 1961 return which, as stipulated, "did not include as income any amount with respect to the sale of rights to purchase Northwest stock or with respect to the exercise of rights to purchase Northwest stock or with respect to the receipt of such stock," he would have been justified in thinking his task was an easy one, at least so far as concerns the point here decided in favor of the taxpayers. Tender of six such rights plus $16 permitted the purchase of a share of Northwest stock at well below market price.[1] Despite the majority's belief that stockholders realize no income simply because of the receipt of "another piece of paper to evidence their same fractional ownership," *Palmer* v. *C. I. R.*, 302 U. S. 63 (1937), as interpreted by this court in *Choate v. C. I. R.*, 129 F. 2d 684 (2 Cir. 1943), taught that the sale of exercise of the Pacific rights was dividend income unless some section of the 1954 Internal Revenue Code dictated otherwise. Examining §355, the section held by my brothers to afford a tax shelter, the agent would have encountered subdivision (a)(1)(D), which requires that:

> "as part of the distribution, the distributing corporation distributes—
>
> (i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or

1 During the offering period the price of the Northwest shares ranged from $28.25 to $25.25. In determining the value of the rights and consequent dividend income the Commissioner used $26, the average price on October 5, 1961, the day the Gordons exercised their warrants. Taxpayers make no claim that the value of the rights on the day of receipt was less than the amount thus determined.

(ii) an amount of stock in the controlled corporation constituting control within the meaning of section 368(c), and it is established to the satisfaction of the Secretary or his delegate that the retention by the distributing corporation of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax."

He would readily have ascertained that Pacific had not met the test of clause (i) since, far from having distributed all the Northwest stock "held by it immediately before the distribution," it retained 13,013,969, approximately 43% of the total of 30,460,000 shares. By the same token Pacific had not complied with clause (ii); the 57% of the stock distributed was nowhere near the 80% "constituting control within the meaning of section 368(c)." If Mr. Gordon had displayed Pacific's letter of February 27, 1961, requesting stockholder assent to the plan and advising "It is expected that within about three years after acquiring the stock of the New Company [Northwest], the Company [Pacific] by one or more offerings will offer for sale the balance of such stock, following the procedure described in the preceding paragraph," the agent could have replied that §355 is concerned with acts rather than expectations. He might also have repeated Mr. Justice Stone's oft-quoted statement, as true today as when written: "All the revenue acts which have been enacted since the adoption of the Sixteenth Amendment have uniformly assessed the tax on the basis of annual returns showing the net result of all the taxpayer's transactions during a fixed accounting period, either the calendar year, or, at the option of the taxpayer, the particular fiscal year which he may adopt." *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359, 363 (1931). The agent

would therefore have been obliged to recommend the determination of a deficiency, so far at least as §355 was the basis asserted for the taxpayers' return, and this without even having to consider the Commissioner's basic claim, recently sustained by the Ninth Circuit, *C. I. R.* v. *Baan*, —— F. 2d —— (1967), that a distribution of rights to purchase the stock of a controlled subsidiary at less than its fair value is not within §355(a)(1)(A).

If a court would have sustained the agent in litigation during 1962, as it seemingly would have had to do, I fail to perceive how Pacific's action in ridding itself of the remaining Northwest shares in 1963 can justify a different result. The 1961 taxes of the Gordons and other minority stockholders depend on what Pacific did in 1961, not on what it chose to do in 1963. *Burnet* v. *Sanford & Brooks Co., supra;* see also *Healy* v. *C. I. R.*, 345 U. S. 278, 281 (1953). When Congress has meant the events of one year to affect the tax for another, it has said so in language all can understand. See e.g., §§172(b), 381, 382, 1301, 1302, 1303. Although the plan adopted by Pacific in 1961 committed it to offer its shareholders "the right to purchase all of the shares of capital stock of the New Company," the plan also provided, subject to an exception not here material, that "the number of shares to be offered to the shareholders of the Pacific Company in any one offering, the number of offerings to be made, and the price at which said shares shall be offered to the shareholders of the Pacific Company shall be determined by the Board of Directors of the Pacific Company in its sole discretion." The qualification was so broad as to deprive the commitment of legal significance, and while in fact the second distribution occurred within 21 months, it is not difficult to think of circumstances, such as adverse regulatory action or re-

strictions on the procurement of telephone plant due to national emergency, that might have postponed Pacific's need for funds and consequent further distribution of Northwest stock for many years. Moreover, if the 1961 distribution of some 57% of the stock can be metamorphosed into a distribution of 100% by what occurred two years later, I assume my brothers would also give the 1963 distribution of 43%, which clearly would not qualify on its own since Northwest was not then a "controlled corporation" within §355(a)(1)(A), see §368(c), the color now attributed to its predecessor. Furthermore, under my brothers' view that a corporation satisfies §355(a)(1)(D) if it ultimately rids itself of all the stock of the controlled corporation, the shelter of §355 would extend to a 1961 Pacific stockholder who sold his stock before 1963 and to a 1963 stockholder who had not owned Pacific stock in 1961. How this jibes with the recognized purpose of §355 to give tax-free treatment where there is "a continuity of the entire business enterprise under modified corporate forms and a continuity of interest in all or part of such business enterprise on the part of those persons who, directly or indirectly, were the owners of the enterprise prior to the distribution," Regulations §1.355-2(c), passes my understanding.

The inspiration for the magic whereby two distributions of 57% and 43% in different years become one of 100% is my brothers' belief that at the end of the process the position of most Pacific stockholders with respect to Northwest shares they had acquired had changed only in their having paid $16 per share to retain what they had owned all along, a feeling—which I share—that the instant transaction was motivated by business considerations and not by a desire for tax avoidance, and an apparent view that

§355(a)(1)(D) was an unnecessary or at least a redundant requirement. Yet the stockholders' investment status would also have been unchanged and the Company's motive equally pure if Pacific had never made the second distribution or if Northwest had been only 79% owned from the outset, and, despite the majority's apparent distaste for the view that distribution of rights to purchase corporate property below market value normally constitutes a dividend, I cannot imagine any court would consider that in such event rights offerings like those here made by Pacific were protected by §355.

Congress has simply not seen fit to exempt all distributions where stockholders' investments remain unchanged from a practical standpoint and no tax avoidance motive is manifest; instead it has chosen to lay down extremely specific conditions which a corporation must follow at its peril if it desires to achieve nonrecognition for its stockholders. Complicated tax statutes particularly invite application of Mr. Justice Holmes' precept, "Men must turn square corners when they deal with the Government," *Rock Island, Ark. & La. R.R.* v. *United States,* 254 U. S. 141, 143 (1920). In §355(a)(1)(D) Congress elected to convert a vague guideline contained in the Regulations under the 1939 Code that "Ordinarily, the business reasons (as distinguished from any desire to make a distribution of earnings and profits to the shareholders) which support the reorganization and the distribution of the stock will require the distribution of all of the stock received by the transferor corporation in the reorganization," Regs. §39.112(b)(11)-2(c), into a specific statutory requirement: Distribute all at once with no questions asked, or, if you prefer, distribute not less than 80% of the stock of the controlled corporation and satisfy the Commissioner that any retention was not

for a forbidden purpose. When Pacific chose not to comply for what it considered valid business reasons, its stockholders must take the consequences.

The Supreme Court has pertinently instructed us to approach revenue acts with the attitude that "the plain, obvious and rational meaning of a statute is always to be preferred to any curious, narrow, hidden sense that nothing but the exigency of a hard case and the ingenuity and study of an acute and powerful intellect would discover." *Old Colony R.R.* v. *C. I. R.*, 284 U. S. 552, 560 (1932), citing *Lynch* v. *Alworth-Stephens Co.*, 267 U.S. 364, 370 (1925). It has also told us that "the words of statutes—including revenue acts—should be interpreted where possible in their ordinary, everyday senses," *Crane* v. *C. I. R.*, 331 U. S. 1, 6 (1947); *Hanover Bank v. C. I. R.*, 369 U. S. 672, 687 (1962). A requirement that a corporation distribute all of a controlled corporation's stock held by it "immediately before the distribution," when read against the basic concept of annual tax accounting, can only mean to distribute all at one time[2]—not to distribute 53% and plan to distribute the rest in a later year or years when and as that suited.[3] With all respect, my brothers seem to be emulating Humpty Dumpty when they say that the words of the statute in "their everyday import" authorize such a course,[4] and that

2 It is setting up a straw man to suggest that this means that the mechanics of a large distribution must be fulfilled "in a single day."

3 There is the further point, noted in Judge Hamley's able opinion in *Baan, supra* —— F. 2d ——, —— n. 22, that the concept of *seriatim* distributions might often be inconsistent with the requirement of §355 (b)(1)(A) and (2)(B) that the distributing and controlled corporations shall have actively conducted a trade or business "throughout the 5-year period ending on the date of such distribution."

4 This comment applies also to such statements as that "The quoted language in no way requires a single distribution," that "there is nothing on the face of this subsection that relates to the number of

the only basis for believing the words mean what they say is the view of a distinguished professor, now endorsed by another court of appeals, who, while thinking that Congress could have been more liberal without seriously affecting the revenue, recognized that "Whatever the validity of the reasons for its existence, §355(a)(1)(D) must of course be complied with," Bittker and Eustice, Federal Income Taxation of Corporation and Shareholders §11.07 at 479 (1966). And we do not satisfactorily answer the Commissioner's claim of administrative difficulties by chiding him for failure to have promulgated regulations that would partially seal up the breach in the statute we are attempting to create today. Unless the words used by Congress lead to absurd results, are inconsistent with its apparent purpose, or are filled by history with a meaning different from the ordinary one, none of which can be successfully asserted here, a court's job is to apply what Congress has said.

Since I am in full accord with the Ninth Circuit that Pacific's decision to bypass the requirement of §355(a)(1)(D) prevents §355 from immunizing the income realized on the exercise of the rights,[5] I find it unnecessary to decide whether that court or the instant majority is right as to the transaction's meeting the basic test, §355(a)(1)(A), of being a distribution solely of stock or securities of a controlled corporation with respect to stock of the distributing corporation. Certainly the words have an uneasy fit to the transaction here in question. What Pacific distributed "with respect to its stock" was not "solely stock or securities" of a controlled corporation but rights to purchase

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transactions, or their timing, which may be contained in a distribution," and that "it is fairly apparent that neither the Code nor the Regulations require, at least by their terms, a single distribution."

5 Taxpayers' arguments based on decisions under predecessors of §351(a) are answered in the opinion in *Baan, supra,* —— F. 2d at ——.

such stock below market price, and the stock of the controlled corporation was distributed "with respect to" the rights rather than the Pacific stock. But even if the distribution of Northwest stock qualified under §355, I could not agree to reversal of the Tax Court's decision that the proceeds of the sale of rights to purchase Northwest stock constituted ordinary income. *Palmer* v. *C. I. R., supra,* along with *Choate* v. *C. I. R.,* 129 F. 2d 684 (2 Cir. 1943), and *Gibson* v. *C. I. R.,* 133 F. 2d 308 (2 Cir. 1943), instruct us that the value of the rights on receipt would be taxable as ordinary income upon their exercise or sale but for some exemptive provision in the Code. Vaulting the language barriers that seem to prevent the issuance of Northwest stock on the exercise of rights from coming within §355, would not help Pacific's stockholders as to rights they sold. As Judge Raum correctly said, the argument "fails to take into account the nature of Section 355, which is a nonrecognition provision, and can be utilized only by those shareholders who come within its terms"—namely, on the majority's view, shareholders who received a distribution of Northwest stock "in respect of" their Pacific stock. The majority's references to §1234 and to *Rank* v. *United States,* 345 F. 2d 337 (5 Cir. 1965), are inapposite; what is here sought to be taxed is the initial value of the rights, not a gain on their sale. Taxpayers argue that the Tax Court's holding creates an unjustifiable distinction between a stockholder who sells rights to purchase stock of a controlled corporation and one who sells the stock of the latter on a when-issued basis and exercises rights to cover the sale. But "the Commissioner is justified in determining the tax effects of transactions on the basis in which taxpayers have molded them," *Television Industries, Inc.* v. *C. I. R.,* 284 F. 2d 322, 325 (2 Cir. 1960). Moreover, the actual answer

may well be that, for reasons heretofore noted, neither the real nor the hypothetical taxpayer is entitled to the benefit of §355.

On the Commissioner's appeal I would reverse the decision as to §355 and remand for consideration of the other grounds advanced by the taxpayers and not dealt with by the Tax Court; on the taxpayers' appeal I would affirm.

UNITED STATES COURT OF APPEALS
Second Circuit

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse in the City of New York, on the twenty-sixth day of July, one thousand nine hundred and sixty-seven.

Present:

Hon. Leonard P. Moore,
Hon. Henry J. Friendly,
Circuit Judges,
Hon. Frederick vP. Bryan,
District Judge.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,
v.
IRVING GORDON and MARGARET GORDON,
Respondents.

IRVING GORDON and MARGARET GORDON,
Petitioners,
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Appeals from The Tax Court of the United States

[JUDGMENT]

This cause came on to be heard on the transcript of record from The Tax Court of the United States, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the order of said The Tax Court of the United States be and it hereby is affirmed in part and reversed in part in accordance with the opinion of this court.

A. Daniel Fusaro
Clerk
By Vincent A. Carlin
Chief Deputy Clerk

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

COMMISSIONER OF INTERNAL REVENUE, *Petitioner*, vs. OSCAR E. BAAN and EVELYN K. BAAN, *Respondents*.	No. 20,863

[July 7, 1967]

On Petition for Review of the Decision of the
Tax Court of the United States

Before: HAMLEY, MERRILL and ELY, Circuit Judges

HAMLEY, Circuit Judge:

The Commissioner of Internal Revenue (Commissioner) determined a deficiency in the 1961 income tax of Oscar E. and Evelyn K. Baan, in the amount of $284.44. Taxpayers petitioned the Tax Court for a redetermination of the Commissioner's finding. The Tax Court decided there was no deficiency, its opinion being reported at 45 T.C. 71. The Commissioner petitioned this court to review that decision.

During 1961, taxpayers owned six hundred shares of Pacific Telephone and Telegraph Company (Pacific) common stock. In that year they received six hundred stock rights, represented by transferable stock purchase warrants issued by Pacific, entitling them to purchase one

share of Pacific Northwest Bell Telephone Company (Northwest) common stock for sixteen dollars and six stock rights.

On October 11, 1961, taxpayers exercised their stock rights and, in consideration for $1,600 ($16 per share) and the surrender of the six hundred stock rights, received one hundred shares of Northwest stock. The fair market value of Northwest common stock on October 11, 1961, was $26.94 per share.

In their joint federal income tax return for that year, taxpayers did not include as income any amount with respect to the issuance of the six hundred rights to purchase Northwest stock, or any amount with respect to the purchase by them of one hundred shares of Northwest stock upon the surrender of the six hundred rights and the payment of $1,600. The Commissioner determined that the difference between the fair market value of the Northwest stock received and the sixteen dollars per share paid constituted a taxable dividend.

In the redetermination proceedings the Tax Court rejected the Commissioner's contention. The issue has been renewed in this review proceeding. The essential facts are not in dispute and the following statement of those facts is taken, almost verbatim, from the Commissioner's opening brief.[1]

Prior to July 1, 1961, Pacific, a California corporation, furnished communication services in California, Oregon, Washington and part of Idaho. Beginning in 1960, the

[1]A more complete statement is set out in the Tax Court's reported statement of facts and opinion, at 45 T.C. 71.

California and non-California businesses of Pacific were operated by separate divisions. For a number of business reasons, the management and shareholders of Pacific decided early in 1961 that the non-California business should be handled by a separate corporation. Accordingly, on March 27, 1961, Pacific caused the organization of Northwest, a Washington corporation. The following day ten thousand shares of Northwest common stock were issued to Pacific upon the payment by Pacific to Northwest of $110,000 in cash.

As of June 30, 1961, all of the business and properties of Pacific in Oregon, Washington and Idaho were transferred to Northwest in exchange for (1) the issuance to Pacific by Northwest of an additional 30,450,000 shares of its common stock, (2) the issuance to Pacific by Northwest of an interest-bearing demand note in the amount of $200,000,000, and (3) assumption by Northwest of certain liabilities of Pacific in Oregon, Washington and Idaho. At the close of business on June 30, 1961, Pacific ceased all operations in Oregon, Washington and Idaho, and Northwest commenced operations in these states on the next day.

An integral part of the plan for dividing the businesses of Pacific was the sale of Northwest stock to Pacific shareholders or their assigns. Assignable stock rights were to be issued to Pacific shareholders which would enable them either to purchase Northwest stock upon surrender of the rights plus the payment of cash in an amount to be set by Pacific's board of directors, or to sell the rights to others who could so exercise them. The purpose of the plan to require a cash payment in addition to the sur-

render of the stock rights was to provide Pacific with funds for its future operations in California.

On August 25, 1961, Pacific's board of directors decided that the offering price of Northwest stock to Pacific shareholders, or to those who had purchased the stock rights from shareholders, should be sixteen dollars per share. Pacific shareholders were to receive one transferable stock purchase warrant for each share of Pacific held, with six rights plus the payment of sixteen dollars required to obtain one share of Northwest stock. Between the time of the issuance of the rights (September 20, 1961) and the deadline for their exercise (October 20, 1961), the fair market value of Northwest stock was no less than twenty-six dollars per share.

The Northwest stock disposed of by Pacific in the above-described 1961 offering amounted to approximately fifty-seven percent of the total number of Northwest shares held by Pacific.[2] It had been planned by Pacific from the

[2] American Telephone and Telegraph Company (American), owned approximately ninety percent of Pacific's common stock. The bulk of the total of 17,446,031 shares of Northwest sold by Pacific in 1961, namely 15,548,140 shares, was thus acquired by American. The minority shareholders of Pacific, or their assignees, acquired the remaining 1,897,891 shares of Northwest. For the Northwest stock it sold in 1961, Pacific received cash in the total amount of $279,136,496.

On the consolidated income tax return filed by American and its subsidiaries for the year 1961 (which return included Pacific) no gain or loss was reported on the transaction in which Pacific transferred its non-California assets to Northwest. Similarly, since it was not required to report gains or losses in certain inter-company transactions, no gain was reported on the 1961 consolidated return on the sale of 15,548,140 shares of Northwest common by Pacific to American. Gain was reported by Pacific, however, in the amount of $8,739,362.07, with respect to the 1,897,891 shares of Northwest sold by Pacific to its minority shareholders or their assignees in 1961.

outset that the remainder would be held for disposition at a later time to be determined by Pacific's board of directors. The remaining forty-three percent of Northwest stock held by Pacific was offered to Pacific's shareholders on June 12, 1963, at the same price of sixteen dollars per share, the principal difference being that eight stock rights, instead of six, were required.[3]

As of December 31, 1960, Pacific had unappropriated earned surplus in the amount of $192,053,880.76. As of December 31, 1961, Pacific had $178,935,190.15 of unappropriated earned surplus. There was a sufficient dollar amount of earnings and profits of Pacific in 1961 from which a 1961 dividend could have been paid by Pacific to its shareholders to cover the dollar amounts which the Commissioner contended in this case were received by taxpayers and other shareholders as dividend income.[4]

On these facts, the Tax Court decided that the transaction whereby Pacific sold its non-California business to Northwest and then sold the Northwest stock to its own

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[3]As a result of the June 12, 1963 offering of the remainder of Northwest stock, American acquired an additional 11,597,417 shares of Northwest, and the minority shareholders of Pacific acquired the remaining 1,416,552 shares of Northwest.

[4]In response to requests by Pacific, the Commissioner issued a ruling letter on June 28, 1961, regarding the tax consequences of the planned division of Pacific and the distribution of Northwest stock through an issue of assignable rights and the payment of cash. Essentially, the Commissioner ruled that, in the case of Pacific's shareholders who sold their rights, the full amount realized would be ordinary income to them and that, in the case of individual Pacific shareholders who exercised their rights, the difference between the fair market value of Northwest stock (on the date the rights were exercised) and the sixteen dollars per share price paid would be taxed to such shareholders as dividend income. On November 15, 1962, the Commissioner issued another ruling letter to Pacific which reaffirmed the position taken in the ruling of June 28, 1961.

shareholders or their assignees, qualified as a tax-free spin-off within the terms and intendment of section 355 of the Internal Revenue Code of 1954, 26 U.S.C. § 355 (1964).[5] Consequently, the Tax Court ruled that the taxpayers were not taxable on the gain realized by them when they exercised their rights to acquire Northwest stock having a fair market value of $26.94 per share at a cost to them of sixteen dollars per share.

As the Tax Court stated in its opinion, there is no serious question that, apart from certain specific provisions of the 1954 Code, the exercise of rights by Pacific's stockholders in the circumstances of this case would result in classifying, as taxable dividends, the excess of the value of the Northwest stock over the subscription price. As indicated above, section 355 was primarily relied upon by taxpayers in seeking, and the Tax Court in granting, non-recognition of the gain realized by taxpayers as a result of their exercise of the rights in question.

The Commissioner argues, however, that four specific requirements of section 355 remain unsatisfied in this case and it was therefore error to grant, on the basis of that statutory provision, non-recognition to this otherwise taxable gain. Section 355 is quoted in the margin.[6] Before

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[5]Section references throughout this opinion will be to the Internal Revenue Code of 1954, unless otherwise expressly stated.

[6]Section 355 reads as follows:

"**§355. Distribution of stock and securities of a controlled corporation.**

"**(a) Effect on distributees.**

"**(1) General rule.**

"If—

"(A) a corporation (referred to in this section as the 'distributing corporation')—

discussing these asserted requirements of section 355, and the question of whether they were here satisfied, it will

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"(i) distributes to a shareholder, with respect to its stock, or

(ii) distributes to a security holder, in exchange for its securities,

solely stock or securities of a corporation (referred to in this section as 'controlled corporation') which it controls immediately before the distribution,

"(B) the transaction was not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both (but the mere fact that subsequent to the distribution stock or securities in one or more of such corporations are sold or exchanged by all or some of the distributees (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device),

"(C) the requirements of subsection (b) (relating to active businesses) are satisfied, and

"(D) as part of the distribution, the distributing corporation distributes—

"(i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or

"(ii) an amount of stock in the controlled corporation constituting control within the meaning of section 368 (c), and it is established to the satisfaction of the Secretary or his delegate that the retention by the distributing corporation of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax,

then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder or security holder on the receipt of such stock or securities.

"**(2) Non pro rata distributions, etc.**

"Paragraph (1) shall be applied without regard to the following:

"(A) whether or not the distribution is pro rata with respect to all of the shareholders of the distributing corporation,

"(B) whether or not the shareholder surrenders stock in the distributing corporation, and

be helpful to review briefly the legislative history of that section.

"(C) whether or not the distribution is in pursuance of a plan of reorganization (within the meaning of section 368(a)(1)(D)).

"**(3) Limitation.**

"Paragraph (1) shall not apply if—

"(A) the principal amount of the securities in the controlled corporation which are received exceeds the principal amount of the securities which are surrendered in connection with such distribution, or

"(B) securities in the controlled corporation are received and no securities are surrendered in connection with such distribution.

"For purposes of this section (other than paragraph (1)(D) of this subsection) and so much of section 356 as relates to this section, stock of a controlled corporation acquired by the distributing corporation by reason of any transaction which occurs within 5 years of the distribution of such stock and in which gain or loss was recognized in whole or in part, shall not be treated as stock of such controlled corporation, but as other property.

"(4) Cross reference.

"**For treatment of the distribution if any property is received which is not permitted to be received under this subsection (including an excess principal amount of securities received over securities surrendered), see section 356.**

"**(b) Requirements as to active business.**

"**(1) In general.**

"Subsection (a) shall apply only if either—

"(A) the distributing corporation, and the controlled corporation (or, if stock of more than one controlled corporation is distributed, each of such corporations), is engaged immediately after the distribution in the active conduct of a trade or business, or

"(B) immediately before the distribution, the distributing corporation had no assets other than stock or securities in the controlled corporations and each of the controlled corporations is engaged immediately after the distribution in the active conduct of a trade or business.

"**(2) Definition.**

"For purposes of paragraph (1), a corporation shall be treated as engaged in the active conduct of a trade or business if and only if—

A spin-off occurs where a part of the assets of a corporation is transferred to a new corporation and the stock of the transferee is distributed to the shareholders of the transferor without the surrender by them of stock in the transferor. See 3 MERTENS, LAW OF FEDERAL INCOME TAXATION (Zimet and Weiss Revision) § 20.100, page 491. Congress apparently first permitted the tax-free treatment of spin-off transactions in section 203(c) of the Revenue Act of 1924, ch. 234, 43 Stat. 256 (1924). Because of the general terms of that and subsequent enactments,[7] Congress soon recognized that wide-spread tax avoidance might result.[8]

"(A) it is engaged in the active conduct of a trade or business, or substantially all of its assets consist of stock and securities of a corporation controlled by it (immediately after the distribution) which is so engaged,

"(B) such trade or business has been actively conducted throughout the 5-year period ending on the date of such distribution,

"(C) such trade or business was not acquired within the period described in subparagraph (B) in a transaction in which gain or loss was recognized in whole or in part, and

"(D) control of a corporation which (at the time of acquisition of control) was conducting such trade or business—

"(i) was not acquired directly or through one or more corporations) by another corporation within the period described in subparagraph (B), or,

"(ii) was so acquired by another corporation within such period, but such control was so acquired only by reason of transactions in which gain or loss was not recognized in whole or in part, or only by reason of such transactions combined with acquisitions before the beginning of such period."

[7]Other similar enactments followed the 1924 statute: Revenue Act of 1926, ch. 27, § 203(c), 44 Stat. 13 (1926); Revenue Act of 1928, ch. 852, § 112(g), 45 Stat. 818 (1928); Revenue Act of 1932, ch. 209, § 112(g), 47 Stat. 197 (1932).

[8]At least arguably, the 1924 statute would have permitted the transfer of liquid assets to a new corporation. The new corporation's shareholders would then be in a position to liquidate the

Congress reacted to this possibility by eliminating the provision which characterized the spin-off as a non-taxable reorganization. See the Revenue Act of 1934, ch. 277, 48 Stat. 680, 704 (1934). From then until 1951, without regard to whether a particular transaction served a legitimate business need, the gain realized by a shareholder as a result of a spin-off was subject to tax as an ordinary dividend.

In 1951, Congress reconsidered its position, having come to the view that business reasons could exist which would justify allowing tax-free status to the division of a single corporation into two or more corporations each owned directly by the shareholders. Therefore, in that year, Congress reinstated non-recognition treatment to those spin-offs which met carefully specified conditions. In so doing Congress additionally provided that ordinary dividend treatment would still be accorded the transaction, even if it would otherwise qualify under the new spin-off provisions, if the transaction was principally used as a "device" for distributing earnings and profits to the shareholders of any corporation that was a party to the reorganization. See section 112(b)(11) of the Internal Revenue Code of 1939, added by section 317 of the Revenue Act of 1951, ch. 521, 65 Stat. 493 (1951).

In the Internal Revenue Code of 1954, Congress sought to create a single set of limitations that would govern all forms of transactions having the potential of either a bona fide business transaction or a tax avoidance scheme.

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new corporation and so receive the liquid assets as a liquidating distribution taxable at capital gains rates. Such a transaction was actually litigated in *Gregory v. Helvering*, 293 U.S. 465. See 3 MERTENS, LAW OF FEDERAL INCOME TAXATION (Zimet and Weiss Revision) §§ 20.55, 20.101, pages 193-203, 496-498.

Under the 1954 Code, which is applicable in this case, such transactions, including not only spin-offs, but also so-called split-offs and split-ups, are to be tested under the provisions of section 355.[9] In addition to further circumscribing the basic prerequisite for non-recognition, section 355 also carried over the "device" restriction that was part of the 1951 legislation. See 3 MERTENS, LAW OF FEDERAL INCOME TAXATION (Zimet and Weiss Revision) § 20.101, pages 494-503.

The Commissioner argues that, in the four following respects, each of which is indispensable, the transaction here in question failed to satisfy essential requirements of section 355:

(1) Pacific did not "distribute" solely stock or securities to taxpayers "with respect to its stock," as assertedly required by section 355(a)(1)(A).

(2) Since Pacific did not distribute "control" of Northwest without consideration, it did not meet the asserted requirements of section 355(a)(1)(D).

(3) Pacific did not distribute control of Northwest in a single distribution, as assertedly required by section 355(a)(1)(D).

(4) Contrary to the requirement of section 355(b)(2)(C), Northwest acquired its telephone busi-

[9] A split-off involves the same kind of transaction as a spin-off except that the shareholders surrender part of their stock in the parent corporation in exchange for stock in the subsidiary. In a split-up, the parent corporation transfers substantially all its assets to two or more corporations and then liquidates, its stockholders surrendering all their stock in the transferor and receiving the stock in the transferee corporations. See Note, *Tax Treatment of Corporate Divisions,* 52 COLUM. L. REV. 408, 409 (1952); Mintz, *Divisive Corporate Reorganizations: Split-Ups and Split-Offs,* 6 TAX L. REV., 365 (1951).

ness from Pacific in a transaction in which gain was "recognized."

We will first consider, together, the first two of these contentions. Both of them are generally directed to the section 355(a)(1)(A) provision that non-recognition of gain will be granted only if the distributing corporation (Pacific) distributes to a shareholder (taxpayers), "with respect to its stock" (with respect to taxpayers' ownership of Pacific's stock), "solely stock or securities" of a controlled corporation (Northwest) which the distributing corporation controls immediately before the distribution.

Beyond question, Pacific distributed stock rights to taxpayers with respect to their ownership of Pacific stock. This is shown by the fact that taxpayers received one stock right for each share of Pacific which they owned, without being required to give any consideration to Pacific.

This is not the kind of distribution, however, which is exempted from taxation under section 355(a)(1)(A). That statutory provision relates "solely" to the distribution of "stock or securities" of the controlled corporation.[10] Further, in view of section 355(a)(1)(D)(ii), which incorporates the "control" definition of section 368(c), the "stock or securities" distributed must carry voting rights. Stock rights are not stocks or securities and, most as-

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[10]The following statement appears in section 1.355-1(a) of the Treasury Regulations on Income Tax (1954 Code): "For the purpose of section 355, stock rights or stock warrants are not included in the term 'stock or securities.'" For a detailed discussion of the term "stock or securities," see 3 MERTENS, LAW OF FEDERAL INCOME TAXATION (Zimet and Weiss Revision) § 20.67, pages 285-286. But see Note, 35 U.CINC.L.REV. 254, 256 (1966).

suredly, are not stocks or securities carrying voting rights. They are only options to purchase stock. See *Helvering v. Southwest Consolidated Corp.*, 315 U.S. 194, 200-201.

It follows that section 355 does not here afford a basis for non-recognition of gain or loss unless the manner in which Northwest stock, as distinguished from the voting rights, was transferred from Pacific to taxpayers, constituted a "distribution" to them with respect to their ownership of Pacific's stock, within the meaning of that section.

For present purposes we may assume that intercession of a stock rights scheme would not, standing alone, prevent a transfer of Northwest stock from Pacific to taxpayers from constituting a distribution with respect to taxpayers' ownership of Pacific's stock. But this stock rights scheme did not stand alone. In addition to surrendering six stock rights, taxpayers were also required to pay sixteen dollars for each share of Northwest stock acquired. The transaction then became a sale of corporate assets.

Although the Supreme Court said in *Palmer v. Commissioner*, 302 U.S. 63, 69, that a sale of corporate assets to stockholders is, in a literal sense, a "distribution" of its property, we do not believe that it is the kind of distribution contemplated by section 355. Instead of being simply a distribution with reference to taxpayers' ownership of Pacific's stock, it is a distribution with reference to that ownership *plus* the payment of sixteen dollars a share.

As the Commissioner correctly states in his argument to this court, whatever meaning may be attached to the

word "distribute," standing by itself or in a different context, the phrase "distributes . . . with respect to . . . stock" is a term of art with a consistent meaning throughout the Code. It is used only to refer to distributions without consideration, not to sales for a cash consideration.[11]

Contrary to taxpayers' contention, there is no contradiction between a view which interprets only distributions without consideration as being within the section 355 phrase, "distributes . . . with respect to . . . stock," and the Commissioner's determination that taxpayers received a distribution from Pacific which is taxable as a dividend under section 301 of the Code, 26 U.S.C. § 301 (1964). It is true that both sections refer to a distribution made by a corporation to a shareholder ". . . with respect to its stock. . . ." However, section 355 relates this provision to the distribution of "solely stock or securities of a corporation . . . ," whereas section 301 relates this provision to the distribution of "property (as defined in section 317(a))."

Section 317(a), 26 U.S.C. § 317 (1964), makes it clear that "property" is not limited to stock or securities but may include "any other property." Thus Pacific's distribution of stock rights "with respect to its stock" logically constitutes the distribution of property within the meaning of section 301, but, for the reasons stated above,

[11]See section 301 (distributions of property), section 305 (distributions of stock and stock rights), section 307 (basis of stock and stock rights acquired in distributions), section 311 (taxability of corporations on distributions), and section 312 (effect of a distribution on corporate earnings and profits).

does not constitute the distribution of "stock or securities" within the meaning of section 355.[12]

The dividend ruling by the Commissioner was with respect to the distribution of assignable stock rights to Pacific shareholders. It is true, as the Supreme Court said in *Palmer v. Commissioner,* 302 U.S. 63, 71, that the mere issue of rights to subscribe and their receipt by shareholders is not a dividend. But where, as in our case, this is coupled with the fact that, at the time of the distribution of stock rights, there is a "spread" between the fair market value of the stock and the purchase price as called for by the stock rights, an intention to declare a dividend is indicated. The amount of the dividend, determinable at the time the shareholder of the distributing corporation exercises his stock rights, is the lower of the

[12]Taxpayers point to sections 1.301-1(j) and (k) of the Treasury Regulations on Income Tax (1954 Code) as contradicting the Commissioner's contention that, throughout the 1954 Code, the phrase "distribution . . . to a shareholder with respect to its stock" never means distribution for a *cash* consideration.

Income Tax Regulation 1.301-1(j) does not pertain to distributions to a shareholder "with respect to its stock," but to the "transfer" of property by a corporation to a shareholder for an amount less than its fair market value in a sale or exchange. With respect to such transaction, this regulation provides that such shareholder shall be "treated" as having received a distribution to which section 301 applies. The plain meaning of this regulation is to bring within the provisions of section 301, certain transactions which are not strictly distributions of property by a corporation "with respect to its stock."

Income Tax Regulation 1.301-1(k) demonstrates how (j) is to be applied, by giving as an example, a purchase by a shareholder, from his corporation, for twenty dollars, property having a fair market value of one hundred dollars. The rule indicates that under these circumstances the amount of the distribution determined under section 301(b) is eighty dollars. This example demonstrates that Regulation 1.301-1(j) does not deal with distributions of corporate property "with respect to its stock," but to other kinds of corporate transfers to shareholders which will nevertheless be treated as if they were stock distributions.

"spread" on the date of issue or the "spread" on the date of exercise. See *Choate v. Commissioner,* 2 Cir., 129 F.2d 684, 687. *Cf. Commissioner v. LeBue,* 351 U.S. 243, 249.[13]

Taxpayers call attention to the fact that, in view of section 355(a)(2)(B), there may be a section 355(a)(1)(A)(i) distribution to a shareholder "with respect to its stock," even though the plan calls for the shareholder to surrender stock in the distributing corporation.[14] Likening such a surrender of stock by a shareholder to the payment of consideration for stock being distributed to a shareholder, taxpayers argue that a distribution of stock of a controlled corporation under a plan which calls for a cash payment by the distributing corporation's shareholders, is likewise a distribution "with respect to its stock."

If, as part of a plan to distribute to its shareholders the stock of a controlled corporation, the distributing corporation requires that recipient shareholders surrender stock in the *distributing* corporation, it is patently a distribution to the shareholder "with respect to its stock," just as much as if no surrender of such stock were required. No factor unassociated with the shareholder's ownership of the distributing corporation's stock has been

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[13]In our case, the value of the Northwest stock on the date of exercise of the rights by the taxpayers did not exceed the value of that stock on the date of issuance of the rights.

[14]The provision of section 355 (a)(2)(B), to the effect that section 355(a)(1) shall be applied without regard to whether or not the shareholder surrenders stock in the distributing corporation, was designed to make section 355(a)(1) applicable to "split-offs" and "split-ups," as well as "spin-offs." MERTENS, LAW OF FEDERAL INCOME TAXATION, Code Commentary, § 355 (a):3, page 219.

introduced. But where the plan requires a cash payment by a recipient shareholder, a new element, unassociated with a shareholder's ownership of the distributing corporation's stock, has been interjected.

As we view it, the impact of the section 355(a)(2)(B) provision to which taxpayers call attention, as related to our problem, runs against, instead of in favor of, taxpayers' position. Congress made clear in this section that a surrender of stock in the distributing corporation would not defeat a section 355(a)(1) transaction, but it made no such exception in the case of plans calling for cash payments from recipient shareholders.[15]

Taxpayers argue that sections 354 and 356 of the Code, 26 U.S.C. §§ 354 and 356 (1964), support their view that section 355 does not preclude the payment of cash by a tax-free distributee. We do not agree. Neither section 354 nor section 356 pertains to a distribution by a corporation "with respect to its stock," which is an express lim-

[15]Taxpayers also direct our attention to the fact that the term "distributes" as used in (ii) of section 355(a)(1)(A) clearly refers to transfers by a corporation for a consideration, namely exchanges by a distributing corporation of stock or securities of the controlled corporation for its own "securities." Taxpayers argue that the surrender of "securities" under this provision is one form of consideration, thereby indicating that the term "distributes . . . with respect to . . . stock," as used in (i) of section 355(a)(1)(A) was intended to be used in its broadest sense, and could include distributions involving a payment of a cash consideration by recipient shareholders.

However, this argument lacks substance when it is noted that the words "with respect to its stock" do not apply to distributions to a "security holder," under section 355(a)(1)(A)(ii), but only to distributions to a "shareholder" under section 355(a)(1)(A)(i). It is subparagraph (i) and not (ii), which is applicable in this case, since taxpayers receive the stock rights as shareholders "with respect to its stock," and not as security holders "in exchange for its securities."

itation in a section 355(a)(1)(A)(i) transaction under which taxpayers have sought to proceed.

In rejecting the Commissioner's contention that the requirement that sixteen dollars be paid for each share of Northwest stock acquired precluded this transaction from being a distribution "with respect to its stock," the Tax Court made this observation in its opinion:

> "If Congress had intended that a distribution of the Northwest stock be treated as tax-free when made without consideration, it is inconceivable that it could have intended the transaction to result in taxable income to the distributees where they *paid out* money in connection with receiving such stock." (Emphasis in original.)

As taxpayers concede, the fundamental basis of nonrecognition of gain or loss under section 355 is that no tax should be imposed when the same people continue to own the same businesses with only formal changes in the business organization.[16] Consistent with that concept section 355(a)(1)(D) provides, in effect, that distributions made pursuant to section 355(a)(1)(A) must be made pursuant to a plan which contemplates a distribution to the shareholders of the distributing corporation of a controlling portion of the stock or securities of the controlled corporation.

Congress could well conclude that the prospect that the same people (shareholders of the distributing company) will continue to own the same business would be undermined if a distribution was effectuated by means of trans-

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[16]See Treasury Regulations on Income Tax (1954 Code) § 1.355-2(c); 3 MERTENS, LAW OF FEDERAL INCOME TAXATION (Zimet and Weiss Revision), § 20.102, page 507.

ferable stock rights, the exercise of which required substantial cash payments. We do not decide whether the transferability of stock rights would, without more, run counter to the overall concept of section 355. But when transferability is coupled with a requirement for a cash payment, it could well be that a substantial number of the distributing corporation's shareholders would, under the circumstances of a particular case, choose to sell their stock rights rather than to themselves make the cash payment which exercise of the stock rights would entail.[17]

Considered in this light, it is not at all inconceivable to us that Congress would be willing to treat a distribution as tax-free when made without consideration, but

[17]The Tax Court was of the opinion that since more than eighty percent of the shares of Northwest had been finally distributed to Pacific shareholders as of 1963, the control requirement of either (i) or (ii) of section 355(a)(1)(D) had been satisfied. However, we are not here concerned with whether, as events finally unfolded, Pacific shareholders obtained control of Northwest. Section 355 is designed to assure that, unless such retention of control is reasonably certain at the time of initial distribution, non-recognition of gain will not be effectuated. Stated differently, fulfillment of the control requisite is to be adjudged as of the date of the initial distribution rather than by recourse to hindsight in each case after the transaction has been fully consummated.

It is therefore immaterial that, in this case, taxpayers did exercise their stock rights and that, upon completion of the plan in question, more than ninety-five percent of the Northwest stock was owned by the same Pacific shareholders to whom the rights to acquire Northwest stock were distributed. This is particularly true in this case because at the time of the original distribution of fifty-seven percent of the Northwest stock in 1961, it could not be determined whether shareholders of the distributing corporation would receive a controlling amount of the stock in Northwest as required by section 355(a)(1)(D).

It is likewise without controlling significance that section 355(a)(1)(B), quoted in note 6 above, was also perhaps designed in part to retain the business in the same ownership by disallowing this reorganization procedure of section 355 to be used as a device for distributing the earnings and profits of the distributing corporation or the controlled corporation, or both.

would be unwilling to so treat a distribution of assignable stock rights which requires a cash payment.

We therefore conclude that, as contended by the Commissioner in his first two arguments advanced on this appeal, Pacific did not distribute Northwest stock to taxpayers "with respect to its stock," as required by section 355(a)(1)(A) and, for this reason, section 355 does not excuse taxpayers from recognition of gain realized by them on the transaction in question.

The conclusion just stated makes it necessary to reverse the Tax Court decision. In addition, an independent reason for reversal is disclosed by the Commissioner's argument that Pacific did not distribute control of Northwest in a single distribution, as assertedly required by section 355(a)(1)(D).[18]

At the outset, we are confronted with the Commissioner's admission that this argument is advanced for the first time in this court. While the Tax Court was not given an opportunity to voice an opinion as to this contention, since it involves a question of law relative to facts which are not in dispute, we may and do, in the exercise of our discretion, consider this additional argument.[19]

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[18]This is the third of the Commissioner's four principal arguments, as listed earlier in this opinion.

[19]In their brief in this court, taxpayers note that this argument is made for the first time on review by this court. They do not contend, however that this circumstance precludes consideration of the argument here, and they have fully responded to the argument on the merits. The considerations for determining whether this court should allow issues to be raised which were not brought before the Tax Court are set forth in *MacRae v. Commissioner*, 9 Cir., 294 F.2d 56, 59, in which a new argument, advanced for the first time in this court was considered and found to be meritorious.

As noted above, Pacific distributed stock purchase rights in September, 1961, and in that year distributed only fifty-seven percent of the Northwest stock which it held. Not until almost two years later, in June, 1963, did Pacific dispose of the remaining forty-three percent of Northwest stock by making another stock purchase right offering. On the basis of these facts, the Commissioner argues that as of 1961, the tax year here in question, Pacific had failed to offer at least eighty percent of the Northwest stock, thereby violating the divestiture of control requirement of Section 355(a)(1)(D).[20]

In support of his single distribution theory, and as an indication that section 355, by necessary implication, requires that the date of distribution of a controlling interest in the controlled corporation be a readily identifiable date at the time of the initial distribution, the Commissioner calls attention to the following: (1) both section 355(a)(1)(A) and section 355(a)(1)(D) require that the distributing corporation be in "control" of the controlled corporation "immediately before" the distribution; (2) section 355(b)(1)(A) requires that "immediately after distribution" both the distributing and the controlled corporation must be engaged in an active business; and (3) section 355(b)(2)(B) requires that the controlled corporation business must have been conducted for

[20]As is apparent from a reading of section 355(a)(1)(D), quoted in note 6 above, as part of the distribution, the distributing corporation must distribute (i) all of the stock in the controlled corporation, or (ii) an amount of stock constituting "control" within the meaning of section 368(c), 26 U.S.C. § 368(c) (1964). "Control," as defined in section 368(c), is the ownership of at least eighty percent of the total combined voting stock in a corporation and at least eighty percent of all other classes of stock of a corporation.

a period of five years, ending on the "date of distribution." See note 6 above, for the full text of these subsections.

In answer, taxpayers in effect contend that section 355 does not require a single "distribution," but only a single "transaction," and that the two transfers of Northwest stock should be viewed as parts of a single transaction because both offerings were "contemplated and required by the plan of reorganization," which was conceived early in 1961. We have examined the exhibits submitted in the Tax Court, however, and find no requirement or general agreement that the remaining stock in Northwest would be distributed in 1963. To the contrary, the plan as explained in the "Proxy Statement" to Pacific shareholders for the 1961 offering of Northwest stock, makes it clear that the remaining shares of Northwest (forty-three percent) would be offered at a "time or times related to its (Pacific's) need for new capital."[21]

Although a "tentative schedule" set forth in Pacific's presentation of its plan does indicate that a second offering of Northwest stock might take place in December, 1962, and a final offering in December, 1963, it is obvious that such a schedule was not binding on Pacific because the only other actual offering of Northwest stock took place in June, 1963. The indefiniteness of the plan to distribute the remaining shares of Northwest is further evidenced by a recital in the Pacific plan for reorganization, to the effect that the number of shares to be offered to Pacific shareholders in any one offering, the number of

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[21]The agreement entered into between Pacific and Northwest incorporated the "Proxy Statement" referred to above.

offerings to be made, and the price at which these shares would be offered would be determined by the board of directors of Pacific "in its sole discretion."

In support of their contention that a single distribution is not required under section 355, taxpayers cite several cases interpreting section 351(a), a corporate organization provision which provides in part:

> "No gain or loss shall be recognized if property is transferred to a corporation . . . by one or more persons solely in exchange for stock or securities in such corporation and *immediately after* the exchange such person or persons are in control . . . of the corporation." (Emphasis supplied.)

In *Halliburton v. Commissioner,* 9 Cir., 78 F.2d 265, summarized by this court in *Commissioner v. Schumacher Wall Board Corporation,* 9 Cir., 93 F.2d 79, 82, we held that although it took twenty-two days and two separate distributions of stock to issue the entire authorized stock of a new corporation, the pre-existing contract which provided for such an arrangement made it necessary to view the entire proceeding as a "single transaction."

Likewise, in *Portland Oil Co. v. Commissioner,* 1 Cir., 109 F.2d 479, the First Circuit noted that the transfers there involved need not be effected simultaneously, "where executed in pursuance of *an antecedent arrangement.*" (Emphasis supplied.) 109 F.2d at 488. The court pointed out, however, that such an arrangement need not be legally binding if made pursuant to a pre-existing agreement between the parties beneficially interested.

For this latter proposition, the court relied upon our decision in *Von's Investment Co., Ltd. v. Commissioner,*

9 Cir., 92 F.2d 861, in which we held that two transfers by different persons may constitute a single transaction even though the transfers were separated by a five-week interval. It is critical to note, however, that this court rested its decision upon a further finding to be thereafter made by the Tax Board as to whether both transfers were made in furtherance of, and for the purpose of executing and putting into effect, the plan of reorganization embodied in an earlier contract between the interested parties.

We do not find the factual situations presented by the cases just discussed to be analogous to the circumstances of the case now before this court. In the instant case the contract between Pacific and Northwest gave no definite date upon which the remaining shares of Northwest would be distributed, and as of 1961, the time of the original distribution of Northwest stock, it was impossible to determine whether the final distribution would take place in two, three or even ten years, depending upon Pacific's need for additional capital.

Additional practical problems in the administration of section 355 would be presented if section 355 were held applicable in these circumstances. Since control could only be established after eighty percent of the Northwest stock had been distributed to Pacific shareholders, it would be impossible for the taxpayers or the Commissioner to evaluate the applicability of the particular provisions of section 355, listed above, until the time when, by subsequent distribution, the eighty percent requirement should be met. Until then, which in this case was 1963, but might just as well have been years later, taxpayers had no way

of knowing whether, in computing their taxes for 1961, the benefits of section 355 were available. Likewise until then, the Commissioner would be held at bay in determining the accuracy of taxpayers' 1961 tax return. Such an interpretation would run counter to the purpose of section 355.[22]

Taxpayers further asse t that other reorganization provisions have always permitted various steps in consummating plans of reorganization as part of a single transaction. Although certain reorganizations may necessitate various steps before a reorganization may be effected, no such circumstance is presented here. It did not require the nearly two-year period which transpired in the instant case to distribute the percentage of Northwest stock required to fit within the provisions of section 355. The only apparent reason for this delay was Pacific's lack of need for additional capital at the time of the original distribution of Northwest stock.[23]

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[22]A practical problem is also posed by section 355(b)(1) and (2), which requires that the distributing corporation must have been conducted for a period of five years ending on "the date of the distribution." Since "control," as defined in section 368(c), did not pass out of Pacific's hands until the 1963 distribution of Northwest stock, this could be considered the "date of distribution." Such an interpretation, however, would allow the distributing corporation to circumvent this 355 subsection by extending the date at which final distribution of control would be completed.

[23]In its presentation of the plan in question, Pacific stated that its reasons for selling about fifty-six percent of the Northwest stock, rather than more or less were as follows: (1) to allow the parent corporation, American, to acquire more than fifty percent control of Northwest and thereby relieve Pacific of the responsibility of such control, and (2) the sale of this percentage of Northwest stock would enable Pacific to obtain the cash needed to pay off its advances from American without having excess cash left over which would have to be temporarily invested at a low return.

Under these circumstances, we think that a fair interpretation of section 355 requires that there be a single transaction in which a controlling interest is transferred and that for two or more distributions to be entitled to treatment as a single transaction transferring control of the controlled corporation to the shareholders of the distributing corporation, such distributions must not extend over any greater period of time than is reasonably necessary considering the practical problems involved in completing such distributions, apart from other considerations such as Pacific here had in mind in extending the distributions over a period of nearly two years. Applying this test, we hold that the control requirement of section 355 has not been met in this case.

In view of our conclusions reached above regarding the inapplicability of section 355 for each of the three reasons discussed, we need not consider the fourth reason advanced by the Commissioner.

In the Tax Court, taxpayers asserted several alternative arguments for the non-taxability of the distribution in question. The Tax Court did not consider and decide those alternative arguments. Since we are now rejecting the application of section 355 under the circumstances of this case, we remand the case to the Tax Court for consideration of taxpayers' alternative arguments.

Reversed and remanded for further proceedings consistent with this opinion.

UNITED STATES COURT OF APPEALS
For the Ninth Circuit

No. 20,863

COMMISSIONER OF INTERNAL REVENUE, *Petitioner,* vs. OSCAR E. BAAN, *Respondent.*	

JUDGMENT

Upon Petition to Review a Decision of The Tax Court of the United States.

This Cause came on to be heard on the Transcript of the Record from The Tax Court of the United States, and was duly submitted.

On Consideration Whereof, it is now here ordered and adjudged by this Court, that the Decision of the said Tax Court of the United States in this Cause, be and hereby is reversed and that this cause be and hereby is remanded to the said Tax Court for further proceedings consistent with the opinion of this Court.

Filed and entered July 7, 1967

SUPREME COURT OF THE UNITED STATES

No. 760, October Term, 1967

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,
v.
IRVING GORDON et ux.

ORDER ALLOWING CERTIORARI

Filed January 15, 1968.

The petition herein for a writ of certiorari to the United States Court of Appeals for the Second Circuit is granted, and the case is placed on the summary calendar.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

Mr. Justice Marshall took no part in the consideration or decision of this petition.

SUPREME COURT OF THE UNITED STATES

No. 781, October Term, 1967

OSCAR E. BAAN et ux.,
Petitioners,
v.
COMMISSIONER OF INTERNAL REVENUE

ORDER ALLOWING CERTIORARI

Filed January 15, 1968

The petition herein for a writ of certiorari to the United States Court of Appeals for the Ninth Circuit is granted. The case is placed on the summary calendar and set for oral argument immediately following No. 760.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

Mr. Justice Marshall took no part in the consideration or decision of this petition.

FILED
OCT 23 1967
JOHN F. DAVIS, CLERK

No. 760

In the Supreme Court of the United States

OCTOBER TERM, 1967

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

IRVING GORDON AND MARGARET GORDON

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

RALPH S. SPRITZER,
Acting Solicitor General,
MITCHELL ROGOVIN,
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Washington, D.C. 20530.

In the Supreme Court of the United States

OCTOBER TERM, 1967

No.

COMMISSIONER OF INTERNAL REVENUE, PETITIONER
v.
IRVING GORDON AND MARGARET GORDON

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

The Solicitor General, on behalf of the Commissioner of Internal Revenue, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Second Circuit in the above-entitled case.

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 4–52)[1] are reported at 45 T.C. 71. The opinion of the Court of Appeals (App. A, *infra*, pp. 9–39) is not yet officially reported.

JURISDICTION

The judgment of the Court of Appeals was entered on July 26, 1967 (App. B, *infra*, p. 41). The juris-

[1] "R." references are to the separately bound Appendix B to the Commissioner's Brief in the Court of Appeals.

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diction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

In 1961, a company transferred part of its operating assets and cash to a newly formed corporation in exchange for all the stock and a demand note of the new company. Then, in the same year, it issued to its own stockholders transferable rights to purchase at $16 per share 57 percent of the stock of the new corporation, which stock then had a fair market value of over $26 per share. It disposed of the remaining 43 percent in 1963 through a similar issuance of rights. The questions presented here relate to the 1961 tax liability of respondents, stockholders of the company, who exercised some and sold others of the rights they received in that year. Those questions are:

1. Whether the 1961 transaction qualified for the nonrecognition of gain that Section 355 affords to some corporate spinoffs, in which event respondents would not be required to report gain with respect to the rights they exercised.

2. Whether the gain respondents realized upon the rights they sold was capital in nature or a dividend taxable as ordinary income.

STATUTE INVOLVED

Section 355 of the Internal Revenue Code of 1954 appears in Appendix C, *infra*, pp. 43–46.

STATEMENT

In accordance with a plan approved by its stockholders in March 1961, Pacific Telephone and Tele-

graph Company (Pacific) separated the businesses it then conducted in Oregon, Washington and Idaho from its California operations. Pacific transferred its non-California assets and liabilities and $110,000 cash to a newly-formed corporation, Pacific Northwest Bell Telephone Company (Northwest). Pacific received in exchange all 30,460,000 shares of Northwest's common stock and a $200,000,000 demand note. That exchange was accomplished by June 30, 1961 (App. A, *infra,* pp. 11, 15).

The plan further provided that all of the Northwest stock ultimately would be sold to Pacific's stockholders. Left to the discretion of Pacific's management were such questions as the number and timing of offerings and the price to be paid for Northwest stock. Those management decisions were to be made in response to the capital requirements of Pacific, although it was anticipated that all of the Northwest stock would be disposed of within three years (App. A, *infra,* p. 15).

On September 20, 1961, Pacific issued to its stockholders one transferable stock right for each outstanding share of Pacific stock. Six of these rights and a payment of $16 were required to purchase one share of Northwest stock. At that time, the fair market value of the Northwest stock was $26 per share. The rights were sufficient to purchase approximately 57 percent of the Northwest stock. On June 12, 1963, the remaining 43 percent was offered on terms which required eight rights and payment of $16 to acquire one share of Northwest stock (App. A, *infra,* pp. 15–16).

Respondents are stockholders of Pacific who received 1,540 stock rights in 1961. They sold four rights for a total price of $6.36, reporting that amount as long-term capital gain. They exercised the remaining rights, as to which they reported no income (App. A, *infra*, pp. 10, 16).

The Commissioner issued a notice of proposed deficiency on the basis that, with respect to the rights which were exercised, respondents received a dividend taxable at ordinary income rates, measured by the difference between the fair market value of $26 and the $16 price of each share of Northwest stock, and that, with respect to the rights sold, respondents received income taxable at ordinary income rates in the amount of the fair market value of the rights (App. A, *infra*, p. 16).

In a suit for a redetermination, the Tax Court held that the basic transaction here qualified for tax-free treatment under Section 355 of the 1954 Code (R. 35–50). The Tax Court further held, however, that the gain realized on the sale of the four stock rights was taxable as a dividend (R. 50–52).

The Second Circuit, Judge Friendly dissenting, agreed that the receipt and exercise of the stock rights qualified for nonrecognition of gain under Section 355, but concluded that the gain realized on the sale of the rights was taxable only as capital gain (App. A, *infra*, pp. 29, 30–31).

REASONS FOR GRANTING THE WRIT

There is a direct conflict between the Second Circuit's decision in this case and the Ninth Circuit's

decision in *Commissioner* v. *Baan* (decided July 7, 1967, 67-2 U.S.T.C., para. 9556). The Baans are other stockholders of Pacific who have litigated the tax consequences of their receipt and exercise of rights in 1961. Since the two cases grew out of the same transaction, they were tried and decided together in the Tax Court. Shortly before the Second Circuit handed down its opinion affirming the Tax Court's holding that the transaction at issue qualified as a nontaxable spinoff under Section 355, the Ninth Circuit, which had jurisdiction of the *Baan* case on appeal, reversed the Tax Court on the same point.

The Ninth Circuit ruled that because the stock rights were transferable and exercise required the payment of $16 for each share of Northwest stock purchased, there had not been a distribution of "solely stock or securities" of Northwest "with respect to [Pacific's] * * * stock," as required by Section 355(a) (1) (A). As an additional independent ground for its decision, the Ninth Circuit, as did Judge Friendly in dissent in the present case, found that Pacific's disposition of only 57 percent of the Northwest stock in 1961, while retaining the other 43 percent until 1963, did not meet the standard of Section 355(a)(1)(D), which permits nonrecognition of gain only if there is a distribution of "all of the stock and securities in the controlled corporation"—here Northwest—that Pacific "held * * * immediately before the distribution," or, in the alternative, a distribution of "an amount of stock * * * constituting 'control' within the meaning of Section 368(c)," *i.e.*, at least 80 percent of the Northwest stock.

The majority of the Second Circuit, however, disregarded the fact that the stock rights were marketable, and treated the cash consideration merely as a capital contribution that did not bar characterization of the entire transaction as a tax-free spinoff. Pacific's 1961 and 1963 offerings were viewed as part of a single transaction by which it "distributed" 100 percent of the Northwest stock, notwithstanding that as of the time of the 1961 offering no final decision had been made or obligation incurred as to whether or when the remainder of the Northwest stock would be offered. In fact, this occurred nearly two years later.

The Ninth Circuit did not have before it the issue of whether the gain realized by Pacific's stockholders who sold rights represented capital gain or dividend income, and therefore its decision technically is not in conflict with that part of the Second Circuit's decision here. Nevertheless, the result in the Second Circuit—that the gain upon sale was capital in nature—was predicated on its holding that the overall transaction qualified under Section 355, so that, in the Second Circuit's view, the two issues were interconnected. Furthermore, the tax liabilities of 2,099 Pacific stockholders have been in abeyance pending the outcome of this litigation, and some will have sold rights. We therefore submit that if certiorari is granted, this Court's review should encompass both questions presented in order that there may be a more complete disposition of the controversy.

In sum, two courts of appeals have adopted quite different approaches to the proper interpretation of a

statutory provision that grants nonrecognition treatment to certain spinoffs. Those courts have consequently reached diametrically opposite conclusions in their consideration of the tax consequences of one transaction. The divergent results prevent the Commissioner from uniformly taxing more than 2,000 Pacific shareholders. In these circumstances review by this Court is plainly warranted.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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OCTOBER 1967.

APPENDIX A

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 214—September Term, 1966

(Argued January 24, 1967 Decided July 26, 1967)

Docket No. 30572

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

IRVING GORDON AND MARGARET GORDON, RESPONDENTS

IRVING GORDON AND MARGARET GORDON, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Before: MOORE and FRIENDLY, *Circuit Judges*

BRYAN,[1] *District Judge*

Petition for review of a decision of the Tax Court of the United States, Raum, *Judge*. The Commissioner of Internal Revenue petitions this Court to re-

[1] For the Southern District of New York, sitting by designation.

view a decision of the Tax Court that a distribution of stock to the taxpayers was governed by Section 355 of the Internal Revenue Code of 1954. Taxpayer seeks review of a decision that the sale of stock rights constituted dividend income Opinion below reported at 45 T. C. 71. Affirmed in part and reversed in part.

MOORE, *Circuit Judge*:

The taxpayers, Irving and Margaret Gordon (husband and wife) in 1961 owned 1,540 shares of Pacific Telephone and Telegraph Company (Pacific) common stock. Their stock certificate represented a fractional part, in theory at least, of all the assets of this company. Although collectively the stockholders owned these assets, the corporate form was not within the control of the individual stockholder but, for all practical purposes, in the control of the company's management. Therefore, when Pacific decided to have its assets held by two corporations instead of one, the position of the Gordons remained unchanged. They merely needed to have another piece of paper to evidence their same fractional asset ownership. This, in substance, Pacific supplied. However, as a result of the transaction, the Commissioner of Internal Revenue (the Commissioner) has assessed an income tax against the Gordons who properly ask, probably in some wonderment, how this corporate change of asset ownership brought income to them and, if so, where is it?

Before considering the facts, which are not in dispute, the trite statement that an income tax should be a tax on income may serve as a beacon. All too frequently, Commissioners and courts launch into an analysis of tax sections, subsections, paragraphs and subparagraphs which practically exhaust the alphabet

and Roman and Arabic numbers. In this intellectual exercise, the taxpayer often is only an incidental (though necessary) figure. Therefore, this review will be based on the principle that the ultimate question to be answered is: did the Gordons receive taxable income within the meaning of the Code because of their ownership of a Pacific stock certificate? It must be presumed that in enacting all the sections of the Code, relating to corporate changes, Congress adhered to the fundamental purpose of taxing income. The Tax Court, 45 T. C. 71, has held that they did not as to 1,536 shares; the Commissioner appeals. As to four (4) stock rights sold, the Tax Court held that income resulted and the Gordons appeal. We affirm the Tax Court as to the Commissioner's appeal and reverse as to the Gordons' (taxpayers') appeal.

The principal question presented by this petition to review the decision of the Tax Court is whether the nonrecognition provisions of Section 355 of the Internal Revenue Code of 1954 can be applied to a spin-off by Pacific of a part of its assets. Pacific is a subsidiary of the American Telephone and Telegraph Company (AT&T) which at all times owned over 80% of Pacific's common stock. Prior to July 1, 1961, Pacific provided the telephone services for California, Oregon, Washington and Idaho.[1] This is a rapidly growing area of the country and for purely business reasons, Pacific decided to divide the corporation. To this end a new corporation, Pacific Northwest Bell Telephone Company (Northwest), was formed to take over the non-California business of Pacific. Pacific's management studied a variety of methods by which to

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[1] Pacific also provided telephone service in Nevada through a wholly-owned subsidiary which was not included in the spin-off here considered.

effect the division, one of which was a conventional spin-off which clearly would have qualified under Section 355.[2] This method was rejected partly because

[2] Section 355 of the Internal Revenue Code of 1954 reads as follows:

"Sec. 355. Distribution of Stock and Securities of a Controlled Corporation.

(a) Effect on Distributees.

(1) General Rule.—If—

(A) a corporation (referred to in this section as the 'distributing corporation')—

(i) distributes to a shareholder, with respect to its stock, or

(ii) distributes to a security holder, in exchange for its securities, solely stock or securities of a corporation (referred to in this section as 'controlled corporation') which it controls immediately before the distribution,

(B) the transaction was not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both (but the mere fact that subsequent to the distribution stock or securities in one or more of such corporations are sold or exchanged by all or some of the distributees (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device),

(C) the requirements of subsection (b) (relating to active businesses) are satisfied, and

(D) as part of the distribution, the distributing corporation distributes—

(i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or

(ii) an amount of stock in the controlled corporation constituting control within the meaning of section 368(c), and it is established to the satisfaction of the Secretary or his delegate that the retention by the distributing corporation of stock (or stock and securities) in the controlled corpora-

of state law obstacles and, presumably, partly because the AT&T family filed a consolidated tax return which eliminated intercorporate dividends and thus qualifi-

> tion was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax,
>
> then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder or security holder on the receipt of such stock or securities.
>
> (2) Non pro rata distributions, etc.—Paragraph (1) shall be applied without regard to the following:
>
> (A) whether or not the distribution is pro rata with respect to all of the shareholders of the distributing corporation,
>
> (B) whether or not the shareholder surrenders stock in the distributing corporation, and
>
> (C) whether or not the distribution is in pursuance of a plan of reorganization (within the meaning of section 368(a)(1)(D)).
>
> (3) Limitation.—Paragraph (1) shall not apply if—
>
> (A) the principal amount of the securities in the controlled corporation which are received exceeds the principal amount of the securities which are surrendered in connection with such distribution, or
>
> (B) securities in the controlled corporation are received and no securities are surrendered in connection with such distribution.
>
> For purposes of this section (other than paragraph (1)(D) of this subsection) and so much of section 356 as relates to this section, stock of a controlled corporation acquired by the distributing corporation by reason of any transaction which occurs within 5 years of the distribution of such stock and in which gain or loss was recognized in whole or in part, shall not be treated as stock of such controlled corporation, but as other property.
>
> (4) Cross Reference.—
>
> For treatment of the distribution if any property is received which is not permitted to be received under this subsection (including an excess principal amount of securities received over securities surrendered), see section 356.

cation under Section 355 was not of great importance to the corporate management. It is, however, vital to the minority Pacific stockholders and to the taxpayers

(b) Requirements as to Active Business.—

(1) In General.—Subsection (a) shall apply only if either—

(A) the distributing corporation, and the controlled corporation (or, if stock of more than one controlled corporation is distributed, each of such corporations), is engaged immediately after the distribution in the active conduct of a trade or business, or

(B) immediately before the distribution, the distributing corporation had no assets other than stock or securities in the controlled corporations and each of the controlled corporations is engaged immediately after the distribution in the active conduct of a trade or business.

(2) Definition.—For purposes of paragraph (1), a corporation shall be treated as engaged in the active conduct of a trade or business if and only if—

(A) it is engaged in the active conduct of a trade or business, or substantially all of its assets consist of stock and securities of a corporation controlled by it (immediately after the distribution) which is so engaged,

(B) such trade or business has been actively conducted throughout the 5-year period ending on the date of the distribution,

(C) such trade or business was not acquired within the period described in subparagraph (B) in a transaction in which gain or loss was recognized in whole or in part, and

(D) control of a corporation which (at the time of acquisition of control) was conducting such trade or business—

(i) was not acquired directly (or through one or more corporations) by another corporation within the period described in subparagraph (B), or

(ii) was so acquired by another corporation within such period, but such control was so acquired only by reason of transactions in which gain or loss was not recognized in whole or in part, or only by reason of such transactions combined with acquisitions before the beginning of such period."

Gordon, who owned 1,540 shares of Pacific common stock. It is their position that regardless of what the Pacific management intended, the distribution should be given the preferred tax treatment provided by Section 355.

The plan ultimately agreed upon required Pacific to transfer to Northwest all of the non-California assets and liabilities plus $110,000 in cash in return for the issuance of 30,460,000 shares of Northwest common stock and an interest bearing demand note in the amount of $200,000,000. The result of these arrangements was to give Northwest a capital structure similar to that of Pacific. On June 30, 1961, Pacific ceased all non-California business. This Plan, which had been accepted by the Pacific shareholders in March of 1961, further required Pacific to offer to its shareholders the right to purchase *all* of the Northwest stock held by Pacific on a pro rata basis. It was left to the sole discretion of the Pacific management, however, to determine the number of offerings of Northwest stock to the Pacific shareholders and the price at which the stock would be made available. The Plan, nevertheless, made it clear that these decisions were to be made in response to the capital requirements of Pacific and it was anticipated that all of the Northwest stock would be distributed within three years. On September 20, 1961, Pacific issued one transferable stock right for each outstanding share of Pacific stock. Six such rights plus a payment of $16 were required to subscribe to one share of Northwest stock, which at this time had a fair market value of $26 per share. This initial distribution involved approximately 57% of the Northwest stock held by Pacific, an amount selected in order to pass control of Northwest to AT&T immediately following the first stage of the distribution. A second and final offering,

the terms of which required eight rights plus $16 to obtain one share of Northwest stock, was made on June 12, 1963, of the remaining 43% of the stock.

Pacific adopted this more complex mechanism for distribution to enable it to satisfy simultaneously its very large requirements for additional capital to finance expansion. In each annual period prior to 1961, Pacific had been required to issue common stock or debentures in an average amount of nearly 200 million dollars per year. In the three years following 1961, however, these capital requirements were satisfied through the funds received from its distribution of Northwest stock and no common stock or debentures were issued.

In response to a request by Pacific, the Commissioner issued a ruling letter prior to the first offering which concluded that the sale of the rights would produce ordinary income and that their exercise would constitute a dividend under Section 301. He further stated that Section 355 would not be applicable.

This appeal involves only the tax year of 1961. The taxpayers exercised 1,536 of the 1,540 rights they received that year. On their income tax return, the taxpayers took the position that this aspect of the transaction was not subject to tax and therefore reported no gain or loss. The other four rights were sold for a total amount of $6.36, which was reported as a capital gain. On July 19, 1963, the Commissioner assessed a deficiency of $895.10 based on these transactions.

I

It is not disputed that the Pacific-Northwest corporate division fulfilled a valid business purpose. Nor is it disputed that the method selected by Pacific to accomplish this division was dictated by valid business reasons. In fact, it does not appear to be disputed that

there was no possibility under this transaction for turning ordinary income into capital gains—the evil which Section 355 was designed to prevent. Rather, the government contends that in a number of technical respects, the requirements of that Section were not met and that, therefore, the distribution of Northwest stock must be treated as a dividend. While the government raises a number of purely technical questions to which we shall shortly turn, the truly decisive question before this Court is how Section 355 shall be construed. The taxpayers argue that Section 355 is the embodiment of a Congressional decision that corporate divisions are desirable as a matter of public policy and should not be impeded by tax considerations. Congress recognized, of course, that corporate divisions are a perfect vehicle for bail-outs of earnings and profits and, therefore, hedged in the use of Section 355 with a number of conditions which must be met. But when the division presents no opportunity for a bail-out, these conditions should not be so construed as to frustrate the basic Congressional purpose. The Commissioner, for his part, argues that Section 355 is merely a tax concession granted by Congress to permit certain narrowly defined transactions. He concludes that, as with all such privileges, the statute is to be narrowly construed.

In evaluating the jurisprudential philosophy of the government, we are not required to limit our search to the instant case in which it serves the Commisioner's purpose to argue for a narrow construction. Initially, we note the long line of cases holding that mere compliance with the reorganization sections does not ensure a tax-free exchange if there is lacking a business purpose or, perhaps a continuity of interest in the transaction. See, e.g., *Gregory* v. *Helvering,* 293 U.S. 465 (1935), *Bazley* v. *Commissioner,* 331 U.S. 737

(1947). While, obviously, the converse of this proposition is not true, these cases properly stand for the proposition that in determining tax results, the courts do not merely look to the literal language of the statute but also view the business transaction as a whole in conjunction with the underlying purpose of the taxing statute. We are not aware of any rule of law that preserves such a salutary tenet of construction for the exclusive benefits of the Commissioner. See *Helvering* v. *Alabama Asphaltic Limestone Co.*, 315 U.S. 179 (1942).[3]

Furthermore, we note that the Commissioner has not always taken such a constricted view of the reorganization sections. When it serves his purpose, the Commissioner has argued that when a reorganization has in fact occurred, it should be taxed under the reorganization sections of the Code even though the strict requirements of the statute have not been met. See, e.g., *Gallagher* v. *Commissioner,* 39 T.C. 144 (1962); *Berghash* v. *Commissioner,* 43 T.C. 743 (1965), *aff'd* 361 F. 2d 257 (2 Cir. 1966).

While we think it beyond dispute that the courts are permitted a certain flexibility in applying the

[3] In sustaining the contention of the taxpayer that a reorganization had occurred, the Court stated:

"Some contention, however, is made that this transaction did not meet the statutory standard because the properties acquired by the new corporation belonged at that time to the committee and not to the old corporation. That is true. Yet, the separate steps were integrated parts of a single scheme. Transitory phases of an arrangement frequently are disregarded under these sections of the revenue acts where they add nothing of substance to the completed affair. *Gregory* v. *Helvering*, 293 U.S. 465; *Helvering* v. *Bashford*, 302 U.S. 454. Here they were no more than intermediate procedural devices utilized to enable the new corporation to acquire all the assets of the old one pursuant to a single reorganization plan." 315 U.S. at 184–85.

Code, it should be added that cases in which the courts must stray from the literal language of the Code in order to achieve its underlying objectives will not be frequent. Conversely, however, undermining the general purposes of the Code through an overly literal application of each of its technical provisions cannot be justified. Here it is evident that the taxpayers' investment remained in corporate solution (aside from the $6.36) and merely changed its form. The only additional factor was the payment of $16 per share which was in reality tantamount to a contribution to capital and that, of course, is no occasion for the imposition of a tax. Nor was there any opportunity for the taxpayers to use this transaction for a bail-out of earnings and profits. On the other hand, if the Commissioner prevails, taxpayers' equity investment will be turned into ordinary income.

Wholly aside from these considerations of a general nature, an examination of the specific objections made by the Commissioner reveals that at the maximum, this division strayed from the literal terms of Section 355 in only very minor respects.

A. "DISTRIBUTES . . . WITH RESPECT TO ITS STOCK"

From the taxpayers' point of view, they found themselves holding two pieces of paper, a certificate for 1,540 shares of Pacific, and a certificate for 1,540 rights, which when exercised, together represented their ownership in Pacific's assets, including a $16 capital contribution, certainly not an income-producing act. They were neither richer nor poorer. Neither the receipt of the rights certificate and its exercise nor the capital contribution produced any income to them. The Tax Court quite properly observed that

> "If Congress had intended that a distribution of the Northwest stock be treated as tax-free

when made without consideration, it is inconceivable that it could have intended the transaction to result in taxable income to the distributees where they *paid out* money in connection with receiving such stock." [Emphasis in original.] 45 T.C. 71.

Subsection (a)(1)(A)(i) requires that the stock of Northwest be distributed by Pacific with respect to the Pacific stock. The Commissioner argues that in fact Pacific distributed only stock rights with respect to its stock and that the Northwest stock was exchanged for six rights, which could have been purchased through the market by anyone and $16 and, thus, qualification under Section 355 is barred because a distribution of stock rights does not satisfy the statute. We think the result contended for by the Commissioner is precluded by *Palmer* v. *Commissioner*, 302 U.S. 63 (1937) and *Choate* v. *Commissioner*, 129 F. 2d 684 (2 Cir. 1942). Normally, the distribution of a stock right has no tax consequences because there is no distribution of corporate property until the right is exercised.[4] A sale or exchange of a stock right prior to exercise results in a tax only because it is an anticipation of gain from an exercise. It follows in this case that it is the actual distribution of the Northwest stock upon the exercise of the rights that is the relevant event and the use of the stock rights as a mere mechanism to accomplish this result should be disregarded. Compare *Kimbell-Diamond Milling Co.* v. *Commissioner,* 14 T.C. 74 (1950), *aff'd* 187 F. 2d 718 (5 Cir. 1951); *Heller* v. *Commissioner,* 2 T.C. 371 (1943), *aff'd* 147 F. 2d 376 (9 Cir. 1945).

Secondly, the Commissioner argues that the phrase "distribution . . . with respect to its stock" is a term

[4] Possible exceptions such as Section 305(b) have no application to the instant transaction.

of art that excludes the use of a cash consideration such as the $16 required here. He cites no authority for this proposition and we are aware of none. It is perfectly obvious that the Code does not contemplate the receipt of cash by a corporation in connection with a distribution with respect to its stock in the sense that some specific section of the Code spells out the tax result. See Sections 311(a) and 312(d). But it scarcely follows that the Code prohibits the receipt of cash or that if the instant transaction is classified as falling within Section 355, the tax consequences cannot be determined. The only additional factor present is the payment of the $16 and that can be treated very simply as a contribution to capital by a shareholder. However, this question is not before us.[5]

The ultimate question before us is whether, when a reorganization is coupled with another transaction, these two transactions can, or should, be re-separated for federal income tax purposes. When it suits the Commissioner's convenience, he has so argued. See, *e.g.,* Rev. Rul. 61–156, 1961–2 C. B. 62; Regulations 1.301–1(e) and 1.331–1(c). And if the Code is to conform as closely as possible to economic reality, such a division should be performed when necessary. Of course, if the coupling itself is promotive of the evils which the taxing statute was designed to prevent, a separation for tax purposes should not be made for then the taxpayers would have obtained the best of all possible results to the prejudice of the fisc. Here the Tax Court concluded that no conceivable purpose would be served by denying tax-relief when the taxpayer paid out cash while such relief was granted absent this expense. The Commissioner answers the Tax

[5] Although Pacific appears to have treated the cash obtained from the minority stockholders as gain from the sale of property, that is no bar to these taxpayers.

Court by arguing that the use of transferable stock rights plus the $16 requirement "predictably will diminish the continuity of ownership." Thus the Commissioner invokes the judicial gloss on the reorganization sections that, with some exceptions, continuity of interest must be maintained. The short answer to this argument is that it was. The doctrine of continuity of interest has never to our knowledge been used to void a reorganization on the ground that some shareholders might have sold their stock. Indeed, such a rule would void each and every attempted reorganization for with rare exceptions, stock can always be sold as Congress expressly permitted in Section 355(a)(1)(B). Rather, this limitation is applied to the actual result of a transaction: was a continuity of interest in fact maintained? Here over 95% of the shareholders in Pacific before 1961 exercised their rights and became shareholders in Northwest. Further, AT&T itself owned over 80% of the Pacific stock and after the division owned over 80% of both Pacific and Northwest. The doctrine of continuity of interest asks no more.[6]

B. "TRANSACTION IN WHICH GAIN OR LOSS WAS RECOGNIZED"

The Commissioner further takes the position that qualification under Section 355 is barred by the requirement of Section 355(b)(2)(C) that the trade or

[6] In *Commissioner* v. *Baan*, —— F. 2d —— (9 Cir. 1967), which arose out of the same corporate division and was decided by the Tax Court with the instant case, it was held that the requirements of Section 355 had not been met. One of the principal grounds of that decision was that while the mere use of stock rights may not preclude a tax-free division, the added condition of a $16 payment barred the application of Section 355 because of the danger that a continuity of interest would not be maintained.

business which is being actively conducted by either the controlled or the distributing corporation was not acquired in a transaction in which gain or loss was recognized. Taxpayers argue, and the Tax Court agreed that because any gain or loss on the intercorporate transaction was eliminated on the consolidated tax return of these affiliated corporations, this condition of the Section was satisfied. Analysis of the purposes underlying subsections (b)(2)(C) and (D) prohibits acceptance of this conclusion because the happenstance of affiliation does not remove the danger of purchasing a corporation for the purpose of distributing its stock as a dividend while avoiding the tax on dividends. However, this same analysis of the statute indicates clearly, we think, that 355(b)(2)(C) has no application to this case. The theory underlying 355(b), the active business requirement, is the prevention of the temporary investment of liquid assets in a new business in preparation for a 355(a) division. The primary danger envisioned by the draftsmen of this Section was the creation of the new business and the safeguard was the five-year provision. The reasoning is that if the new business must be operated for at least five years, there will be little incentive to use this device for tax avoidance purposes. The second danger was that instead of creating a new business, the corporation would purchase one which had been in existence for over five years and then distribute its stock in place of a dividend. To safeguard against this possibility, subsections (b)(2)(C) and (D) prohibit acquisition of a trade or business, or of a corporation, in a transaction in which gain or loss was recognized. In our case no new business, no new assets and no new corporation was acquired at all. No liquid assets were temporarily invested nor, in fact, was there any temporary investment. Consequently, the application of

these sections to the instant transaction would serve no purpose at all. We think that the draftsmen of Section 355 intended these subsections to apply only to the bringing of new assets within the combined corporate shells of the distributing and the controlled corporations. Therefore, it is irrelevant in this case whether gain was recognized on the intercorporate transfer.

C. SINGLE DISTRIBUTION

Finally, the Commissioner argues that there is an implied requirement in Section 355 that the distribution of stock take place in a single offering and since Pacific utilized two offerings separated by almost two years, the statutory requirement has not been met. It is conceded that there is no direct authority for this proposition but the Commissioner argues that such a result is demanded by the scheme of Section 355. In particular, he refers to subsection (a)(1)(D) which reads as follows:

> (D) as part of the distribution, the distributing corporation distributes—
>
> (i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or
>
> (ii) an amount of stock in the controlled corporation constituting control within the meaning of section 368(c), and it is established to the satisfaction of the Secretary or his delegate that the retention by the distributing corporation of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax,
>
> *　　*　　*　　*　　*

On its face, this subsection is simply the embodiment of the Congressional decision that only complete, and not partial, divisions were to receive tax-free

status and its purpose seems limited to establishing the amount of stock which must be distributed for qualification under Section 355. Both subdivisions require that the distributing corporation distribute an amount of stock in the controlled corporation constituting control. Subdivision (D)(i) imposes the additional requirement that the distributing corporation distribute all of the stock held "immediately before" the distribution to its shareholders, even if that amount is less than all of the outstanding stock. The quoted language in no way requires a single distribution but is merely the means used to permit distribution of less than all of the outstanding stock in the controlled corporation. Alternatively, the corporation may proceed under (D)(ii) which permits retention of stock to a limited degree. Permitting retention at all is a departure from prior law and from the Congressional policy of complete division at the corporate level. To prevent abuse, Congress added to this subdivision a requirement that the taxpayer affirmatively demonstrate the absence of tax avoidance objectives instead of requiring the Commissioner to move under subsection (a)(1)(B). Here again, the fact that Congress permitted limited retention after the completion of the distribution cannot be said to imply that the distribution must have but a single phase. Thus there is nothing on the face of this subsection that relates to the number of transactions, or their timing, which may be contained in a distribution. These matters are entirely governed by the more flexible "device" clause of Section 355(a)(1)(B) which is fully adequate for this purpose and which clearly is no bar to the qualification of this corporate division. As there is no dispute that in both the original plan and in the fact a complete division occurred, applying the statute in this, the most obvious, manner and giving its words

their everyday import compel the conclusion that subsection (a)(1)(D) was satisfied.

The Commissioner, however, contends that the requirements of subsection (a)(1)(D) "undoubtedly" were designed to prevent periodic distributions of stock in the controlled corporation as a substitute for dividends. The only authority for this proposition is Professor Bittker who, in discussing the requirement of explaining retention to the Secretary, "presumes" this purpose. But Professor Bittker was not addressing himself to the question of a single distribution and the Commissioner omits to cite his further observation in the same paragraph that such an abuse would clearly be prohibited by subsection 355(a)(1)(B), the "device" clause, and thus if that is the purpose of the subsection, it is redundant. He further notes that there does not appear to be any necessity for the provision in any event. Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders 479 (2 Ed. 1966). Another commentator states that the requirement of subsection (a)(1)(D) "is designed to differentiate between genuine separations and incidental distributions of a controlled corporation's stock which take the place of current cash dividends." Surrey & Warren, Federal Income Taxation 1640 (1962). The Commissioner does not suggest that the instant transaction was not a genuine division nor could it conceivably be considered a substitute for a current dividend.

Whether a corporation has retained stock or distributed it is simply a question of the point in time that the manipulation is examined. The Commissioner argues that this point is immediately after the first transaction and that subsection (a)(1)(D)(ii) prohibits "retaining" over 20% of the stock after this point. The taxpayers argue that the time is after the

culmination of the plan of distribution and that subsection (a)(1)(D)(ii) only prohibits an indefinite retention.[7] On its face Section 355 gives little guidance but we do know that neither of the purposes suggested for subsection (a)(1)(D) will be defeated by permitting more than one distribution and that the construction of that provision for which the Commissioner argues does not fit easily within its language. But an adequate restriction is already provided by subsection (a)(1)(B).

Further, the incongruity of the result urged by the Commissioner when viewed against other provisions of the Code creates considerable doubt that Congress would intentionally require a single distribution. In 1961 Pacific was the eighth largest non-financial company in the United States and had over 38,000 shareholders. The reorganization resulted in a distribution of over 30 million shares of Northwest stock and raised for Pacific nearly one-half billion dollars. A requirement that such a transaction occur on a single day would be staggering. As far as this Court is aware, none of the other reorganization sections impose such a requirement, aside from the highly limited scope of *Bausch & Lomb Optical Co. v. Commissioner*, 276 F. 2d 75 (2 Cir. 1959), which is not relevant here. Regulations 1.368–2(c); Rev. Rul. 58–93, 1958–1 C. B. 188. See also Sections 332(b) and 337(a).

As it is fairly apparent that neither the Code nor the Regulations require, at least by their terms, a single distribution, such a requirement cannot be read

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[7] While the Plan adopted by Pacific theoretically might have permitted this, the surrounding facts make it certain, as found below, that long-term retention was never intended and, of course, was not the fact. In the future, it would be preferable that such plans set out the timetable of distribution more precisely, as undoubtedly the Commissioner will require.

into the Code, at least without a substantial reason. A fair reading of the Commission's brief indicates that he fears two problems from the result reached below. First, he suggests the danger of periodic distributions as a substitute for dividends and the tax avoidance that this would permit. But as we have noted, it is not clear that there are tax avoidance possibilities in such a scheme so long as the active business requirements are met; if they could be shown to exist, the "device" clause would prohibit any bail-out.

Second, the Commissioner points to a number of administrative difficulties inherent in permitting more than a single distribution such as leaving open the tax result for several years, the problem of defining the "date of distribution," and the difficulty in ascertaining whether there was control "immediately before" the distribution.[8] But the facts of this case can hardly be said to create the insurmountable administrative difficulties which the Commissioner has paraded before us in his brief. Here only two transactions occurred covering a maximum of three tax years. In fact, the deficiency notice in this case was not sent until July of 1963, two months after the second distribution was authorized. The Commissioner attacks the Tax Court by asserting that its opinion would permit ten distributions of 10% of the Northwest stock, an assertion most doubtful in itself for it overlooks the impact of subsection (a)(1)(B). But that is not our case and it can scarcely be contested

[8] The fact that the two transactions which we hold constituted a single distribution occurred in different tax years is of no significance. Had the transactions occurred in January and December of 1961, we would be faced with the same questions as this case presents. The Commissioner makes no point of the fact that two tax years are involved, nor could he. See *Pridemark, Inc.* v. *Commissioner*, 345 F. 2d 34 (4 Cir. 1965).

that the Code imposes a tax on facts, not expectations. Perhaps the enormity of the administrative difficulties may be measured in part by the failure of the Commissioner to raise the single distribution point in the Tax Court.[9]

Conceding that some administrative problems will arise from our decision, they hardly provide a justification for denying tax-free reorganization status to a legitimate spin-off that entails none of the tax avoidance features that Section 355 was designed to prevent. In any event, we think it is the task of the Commissioner to resolve these difficulties, not the courts'. Nothing in our opinion prevents the Commissioner from drafting reasonable Regulations limiting the time period within which the entire distribution must be made, or the number of transactions which may be involved, or specifying what advance notice must be provided the Service, or defining the statutory language quoted above. But we are not prepared to apply retrospectively restrictions directed at evils which this case does not present.

The decision of the Tax Court on the Commissioner's petition is affirmed.

II

Four of the stock rights issued by Pacific were sold by taxpayers for a total amount of $6.36. The Tax Court determined that aside from the effect of Sec-

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[9] In *Commissioner* v. *Baan*, *supra*, the Ninth Circuit alternatively held that while a single distribution was not required by subsectioin (a)(1)(D), because of the difficulties in administration, "such distributions must not extend over any greater period of time than is reasonably necessary considering the practical problems involved in completing such distributions." While this approach effectively compromises the harshness of the Commissioner's argument, the statute contains no such requirement.

tion 355, this distribution by Pacific would be taxable as a dividend. The Court further held that Section 355 could have no application until there had actually been a distribution of stock and, thus, where the rights were disposed of prior to exercise, Section 355 had no application. Such an asymmetrical approach to Section 355 is untenable.

It is well settled that the exercise of a stock right may result in dividend income if the fair market value of the acquired stock exceeds the option price. *Palmer* v. *Commissioner,* 302 U.S. 63 (1937), *Choate* v. *Commissioner,* 129 F. 2d 684 (2 Cir. 1942). And since the sale of a right may be an anticipatory realization of dividend income, gain on the sale is similarly taxed at ordinary income rates. *Helvering* v. *Horst,* 311 U.S. 112 (1940), *Gibson* v. *Commissioner,* 133 F. 2d 308 (2 Cir. 1943). However, in a transaction to which Section 355 applies, the distribution of stock by a corporation does not result in a dividend even though the distribution was accomplished by the use of stock rights and the option price was less than the fair market value of the acquired stock. The assumption of such cases as *Palmer* and *Gibson* is that a distribution of corporate earnings results from the existence of a "spread." Section 355, on the other hand, is a statutory device for determining that a distribution of capital, rather than of earnings, has occurred and therefore the assumption of those cases is inapplicable. The reasoning of *Gibson,* however, that the sale of a stock right should be taxed the same as an exercise is controlling. Similar reasoning exists in Code Section 1234(a). And see *Rank* v. *United States,* 345 F. 2d 337 (5 Cir. 1965). Since the gain on an exercise of these rights, although deferred until the sale of the stock, would be capital, we hold that the sale of the rights similarly gave rise to capital gains. The error

of the Tax Court was in forgetting that it is not the individual shares of stock received by these taxpayers that qualify under Section 355 but the entire distribution by Pacific.

The decision of the Tax Court on the taxpayers' petition is reversed.

FRIENDLY, *Circuit Judge* (dissenting):

If in 1962 a revenue agent had reviewed the Gordons' 1961 return which, as stipulated, "did not include as income any amount with respect to the sale of rights to purchase Northwest stock or with respect to the exercise of rights to purchase Northwest stock or with respect to the receipt of such stock," he would have been justified in thinking his task was an easy one, at least so far as concerns the point here decided in favor of the taxpayers. Tender of six such rights plus $16 permitted the purchase of a share of Northwest stock at well below market price.[10] Despite the majority's belief that stockholders realize no income simply because of the receipt of "another piece of paper to evidence their same fractional ownership," *Palmer* v. *C.I.R.*, 302 U.S. 63 (1937), as interpreted by this court in *Choate* v. *C.I.R.*, 129 F. 2d 684 (2 Cir. 1943), taught that the sale of exercise of the Pacific rights was dividend income unless some section of the 1954 Internal Revenue Code dictated otherwise. Examining § 355, the section held by my brothers

[10] During the offering period the price of the Northwest shares ranged from $28.25 to $25.25. In determining the value of the rights and consequent dividend income the Commissioner used $26, the average price on October 5, 1961, the day the Gordons exercised their warrants. Taxpayers make no claim that the value of the rights on the day of receipt was less than the amount thus determined.

to afford a tax shelter, the agent would have encountered subdivision (a)(1)(D), which requires that:

> "as part of the distribution, the distributing corporation distributes—
> (i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or
> (ii) an amount of stock in the controlled corporation constituting control within the meaning of section 368(c), and it is established to the satisfaction of the Secretary or his delegate that the retention by the distributing corporation of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax."

He would readily have ascertained that Pacific had not met the test of clause (i) since, far from having distributed all the Northwest stock "held by it immediately before the distribution," it retained 13,013,969, approximately 43% of the total of 30,460,000 shares. By the same token Pacific had not complied with clause (ii); the 57% of the stock distributed was nowhere near the 80% "constituting control within the meaning of section 368(c)." If Mr. Gordon had displayed Pacific's letter of February 27, 1961, requesting stockholder assent to the plan and advising "It is expected that within about three years after acquiring the stock of the New Company [Northwest], the Company [Pacific] by one or more offerings will offer for sale the balance of such stock, following the procedure described in the preceding paragraph," the agent could have replied that § 355 is concerned with acts rather than expectations. He might also have repeated Mr. Justice Stone's oft-quoted statement, as true today as when written: "All the revenue acts which have been enacted since the adoption of the Sixteenth Amendment have uniformly assessed the

tax on the basis of annual returns showing the net result of all the taxpayer's transactions during a fixed accounting period, either the calendar year, or, at the option of the taxpayer, the particular fiscal year which he may adopt." *Burnet* v. *Sanford & Brooks Co.,* 282 U.S. 359, 363 (1931). The agent would therefore have been obliged to recommend the determination of a deficiency, so far at least as § 355 was the basis asserted for the taxpayers' return, and this without even having to consider the Commissioner's basic claim, recently sustained by the Ninth Circuit, *C. I. R.* v. *Baan,* —— F. 2d —— (1967), that a distribution of rights to purchase the stock of a controlled subsidiary at less than its fair value is not within § 355(a)(1)(A).

If a court would have sustained the agent in litigation during 1962, as it seemingly would have had to do, I fail to perceive how Pacific's action in ridding itself of the remaining Northwest shares in 1963 can justify a different result. The 1961 taxes of the Gordons and other minority stockholders depend on what Pacific did in 1961, not on what it chose to do in 1963. *Burnet* v. *Sanford & Brooks Co., supra*; see also *Healy* v. *C.I.R.* 345 U.S. 278, 281 (1953). When Congress has meant the events of one year to affect the tax for another, it has said so in language all can understand. See, e.g., §§ 172(b), 381, 382, 1301, 1302, 1303. Although the plan adopted by Pacific in 1961 committed it to offer its shareholders "the right to purchase all of the shares of capital stock of the New Company," the plan also provided subject to an exception not here material, that "the number of shares to be offered to the shareholders of the Pacific Company in any one offering, the number of offerings to be made, and the price at which said shares shall be offered to the shareholders of the Pacific Company shall be deter-

mined by the Board of Directors of the Pacific Company in its sole discretion." The qualification was so broad as to deprive the commitment of legal significance, and while in fact the second distribution occurred within 21 months, it is not difficult to think of circumstances, such as adverse regulatory action or restrictions on the procurement of telephone plant due to national emergency, that might have postponed Pacific's need for funds and consequent further distribution of Northwest stock for many years. Moreover, if the 1961 distribution of some 57% of the stock can be metamorphosed into a distribution of 100% by what occurred two years later, I assume my brothers would also give the 1963 distribution of 43%, which clearly would not qualify on its own since Northwest was not then a "controlled corporation" within § 355 (a)(1)(A), see § 368(c), the color now attributed to its predecessor. Furthermore, under my brothers' view that a corporation satisfies § 355(a)(1)(D) if it ultimately rids itself of all the stock of the controlled corporation, the shelter of § 355 would extend to a 1961 Pacific stockholder who sold his stock before 1963 and to a 1963 stockholder who had not owned Pacific stock in 1961. How this jibes with the recognized purpose of § 355 to give tax-free treatment where there is "a continuity of the entire business enterprise under modified corporate forms and a continuity of interest in all or part of such business enterprise on the part of those persons who, directly or indirectly, were the owners of the enterprise prior to the distribution" Regulations § 1.355–2(c), passes my understanding.

The inspiration for the magic whereby two distributions of 57% and 43% in different years become one of 100% is my brothers' belief that at the end of the process the position of most Pacific stockholders with respect to Northwest shares they had

acquired had changed only in their having paid $16 per share to retain what they had owned all along, a feeling—which I share—that the instant transaction was motivated by business considerations and not by a desire for tax avoidance, and an apparent view that § 355(a)(1)(D) was an unnecessary or at least a redundant requirement. Yet the stockholders' investment status would also have been unchanged and the Company's motive equally pure if Pacific had never made the second distribution or if Northwest had been only 79% owned from the outset, and, despite the majority's apparent distate for the view that distribution of rights to purchase corporate property below market value normally constitutes a dividend, I cannot imagine any court would consider that in such event rights offerings like those here made by Pacific were protected by § 355.

Congress has simply not seen fit to exempt all distributions where stockholders' investments remain unchanged from a practical standpoint and no tax avoidance motive is manifest; instead it has chosen to lay down extremely specific conditions which a corporation must follow at its peril if it desires to achieve nonrecognition for its stockholders. Complicated tax statutes particularly invite application of Mr. Justice Holmes' precept, "Men must turn square corners when they deal with the Government," *Rock Island, Ark. & La. R.R.* v. *United States*, 254 U.S. 141, 143 (1920). In § 355(a)(1)(D) Congress elected to convert a vague guideline contained in the Regulations under the 1939 Code that "Ordinarily, the business reasons (as distinguished from any desire to make a distribution of earnings and profits to the shareholders) which support the reorganization and the distribution of the stock will require the distribution of all of the stock received by the transferor corporation in the re-

organization," Regs. § 39.112(b)(11)2(c), into a specific statutory requirement: Distribute all at once with no questions asked, or, if you prefer, distribute not less than 80% of the stock of the controlled corporation and satisfy the Commissioner that any retention was not for a forbidden purpose. When Pacific chose not to comply for what it considered valid business reasons, its stockholders must take the consequences.

The Supreme Court has pertinently instructed us to approach revenue acts with the attitude that "the plain, obvious and rational meaning of a statute is always to be preferred to any curious, narrow, hidden sense that nothing but the exigency of a hard case and the ingenuity and study of an acute and powerful intellect would discover." *Old Colony R.R.* v. *C. I. R.*, 284 U.S. 552, 560 (1932), citing *Lynch* v. *Alworth-Stephens Co.*, 267 U.S. 364, 370 (1925). It has also told us that "the words of statutes—including revenue acts—should be interpreted where possible in their ordinary, everyday senses," *Crane* v. *C. I. R.*, 331 U.S. 1, 6 (1947); *Hanover Bank* v. *C. I. R.*, 369 U.S. 672, 687 (1962). A requirement that a corporation distribute all of a controlled corporation's stock held by it "immediately before the distribution," when read against the basic concept of annual tax accounting, can only mean to distribute all at one time [11]—not to distribute 53% and plan to distribute the rest in a later year or years when and as that suited.[12] With all respect, my brothers seem to be emulating Humpty Dumpty when they say that the words of the statute in "their everyday import" authorize

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[11] It is setting up a straw man to suggest that this means that the mechanics of a large distribution must be fulfilled "in a single day."

[12] There is the further point, noted in Judge Hamley's able opinion in *Baan*, *supra*, —— F. 2d ——, —— n. 22, that the

such a course,[13] and that the only basis for believing the words mean what they say is the view of a distinguished professor, now endorsed by another court of appeals, who, while thinking that Congress could have been more liberal without seriously affecting the revenue, recognized that "Whatever the validity of the reasons for its existence, § 355(a)(1)(D) must of course be complied with." Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders § 11.07 at 479 (1966). And we do *not satisfactorily answer the Commissioner's* claim of administrative difficulties by chiding him for failure to have promulgated regulations that would partially seal up the breach in the statute we are attempting to create today. Unless the words used by Congress lead to absurd results, are inconsistent with its apparent purpose, or are filled by history with a meaning different from the ordinary one, none of which can be successfully asserted here, a court's job is to apply what Congress has said.

Since I am in full accord with the Ninth Circuit that Pacific's decision to bypass the requirement of § 355(a)(1)(D) prevents § 355 from immunizing the

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concept of *seriatim* distributions might often be inconsistent with the requirement of § 355(b)(1)(A) and (2)(B) that the distributing and controlled corporations shall have actively conducted a trade or business "throughout the 5-year period ending on the date of such distribution."

[13] This comment applies also to such statements as that "The quoted language in no way requires a single distribution," that "there is nothing on the face of this subsection that relates to the number of transactions, or their timing, which may be contained in a distribution," and that "it is fairly apparent that neither the Code nor the Regulations require, at least by their terms, a single distribution."

income realized on the exercise of the rights,[14] I find it unnecessary to decide whether that court or the instant majority is right as to the transaction's meeting the basic test, § 355(a)(1)(A), of being a distribution solely of stock or securities of a controlled corporation with respect to stock of the distributing crporation. Certainly the words have an uneasy fit to the transaction here in question. What Pacific distributed "with respect to its stock" was not "solely stock or securities" of a controlled corporation but rights to purchase such stock below market price, and the stock of the controlled corporation was distributed "with respect to" the rights rather than the Pacific stock. But even if the distribution of Northwest stock qualified under § 355, I could not agree to reversal of the Tax Court's decision that the proceeds of the sale of rights to purchase Northwest stock constituted ordinary income. *Palmer* v. *C. I. R., supra,* along with *Choate* v. *C.I.R.,* 129 F. 2d 684 (2 Cir. 1943), and *Gibson* v. *C.I.R.,* 133 F. 2d 308 (2 Cir. 1943), instruct us that the value of the rights on receipt would be taxable as ordinary income upon their exercise or sale but for some exemptive provision in the Code. Vaulting the language barriers that seem to prevent the issuance of Northwest stock on the exercise of rights from coming within § 355, would not help Pacific's stockholders as to rights they sold. As Judge Raum correctly said, the argument "fails to take into account the nature of Section 355, which is a nonrecognition provision, and can be utilized only by those shareholders who come within its terms"—namely, on the majority's view, shareholders who re-

[14] Taxpayers' arguments based on decisions under predecessors of § 351(a) are answered in the opinion in *Baan, supra,* —— F. 2d at ——.

ceived a distribution of Northwest stock "in respect of" their Pacific stock. The majority's references to § 1234 and to *Rank v. United States*, 345 F. 2d 337 (5 Cir. 1965), are inapposite; what is here sought to be taxed is the initial value of the rights, not a gain on their sale. Taxpayers argue that the Tax Court's holding creates an unjustifiable distinction between a stockholder who sells rights to purchase stock of a controlled corporation and one who sells the stock of the latter on a when-issued basis and exercises rights to cover the sale. But "the Commissioner is justified in determining the tax effects of transactions on the basis in which taxpayers have molded them," *Television Industries, Inc. v. C.I.R.*, 284 F. 2d 322, 325 (2 Cir. 1960). Moreover, the actual answer may well be that, for reasons heretofore noted, neither the real nor the hypothetical taxpayer is entitled to the benefit of § 355.

On the Commissioner's appeal I would reverse the decision as to § 355 and remand for consideration of the other grounds advanced by the taxpayers and not dealt with by the Tax Court; on the taxpayers' appeal I would affirm.

APPENDIX B

[Caption omitted.]

This cause came on to be heard on the transcript of record from the Tax Court of the United States, and was argued by counsel.

ON CONSIDERATION WHEREOF IT IS NOW HEREBY ORDERED, ADJUDGED, AND DECREED that the order of said The Tax Court of the United States be and it hereby is affirmed in part and reversed in part in accordance with the opinion of this Court.

A. DANIEL FUSARO,
Clerk.

By VINCENT A. CARLIN,
Chief Deputy Clerk.

APPENDIX C

Internal Revenue Code of 1954:

SEC 355. DISTRIBUTION OF STOCK AND SECURITIES OF A CONTROLLED CORPORATION.

(a) *Effect on Distributees.*—

(1) *General rule.*—If—

(A) a corporation (referred to in this section as the "distributing corporation")

(i) distributes to a shareholder, with respect to its stock, or

(ii) distributes to a security holder, in exchange for its securities,

solely stock or securities of a corporation (referred to in this section as "controlled corporation") which it controls immediately before the distribution,

(B) the transaction was not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both (but the mere fact that subsequent to the distribution stock or securities in one or more of such corporations are sold or exchanged by all or some of the distributees (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device),

(C) the requirements of subsection (b) (relating to active businesses) are satisfied, and

(D) as part of the distribution, the distributing corporation distributes—

(i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or

(ii) an amount of stock in the controlled corporation constituting control within the meaning of section 368(c), and it is established to the satisfaction of the Secretary or his delegate that the retention by the distributing corporation of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax,

then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder or security holder on the receipt of such stock or securities.

(2) *Non pro rata distributions, etc.*—Paragraph (1) shall be applied without regard to the following:

(A) whether or not the distribution is pro rata with respect to all of the shareholders of the distributing corporation,

(B) whether or not the shareholder surrenders stock in the distributing corporation, and

(C) whether or not the distribution is in pursuance of a plan of reorgonization (within the meaning of section 368(a)(1)(D)).

(3) *Limitation.*—Paragraph (1) shall not apply if—

(A) the principal amount of the securities in the controlled corporation which are received exceeds the principal amount of the securities which are surrendered in connection with such distribution, or

(B) securities in the controlled corporation are received and no securities are surrendered in connection with such distribution.

For purposes of this section (other than paragraph (1)(D) of this subsection) and so much of section 356 as relates to this section, stock of a controlled corporation acquired by the distributing corporation by

reason of any transaction which occurs within 5 years of the distribution of such stock and in which gain or loss was recognized in whole or in part, shall not be treated as stock of such controlled corporation, but as other property.

(4) *Cross reference.*—

For treatment of the distribution if any property is received which is not permitted to be received under this subsection (including an excess principal amount of securities received over securities surrendered), see section 356.

(b) ***Requirements as to Active Business.***—

(1) *In general.*—Subsection (a) shall apply only if either—

(A) the distributing corporation, and the controlled corporation (or, if stock of more than one controlled corporation is distributed, each of such corporations), is engaged immediately after the distribution in the active conduct of a trade or business, or

(B) immediately before the distribution, the distributing corporation had no assets other than stock or securities in the controlled corporations and each of the controlled corporations is engaged immediately after the distribution in the active conduct of a trade or business.

(2) *Definition.*—For the purposes of paragraph (1), a corporation shall be treated as engaged in the active conduct of a trade or business if and only if—

(A) it is engaged in the active conduct of a trade or business, or substantially all of its assets consist of stock and securities of a corporation controlled by it (immediately after the distribution) which is so engaged,

(B) such trade or business has been actively conducted throughout the 5-year period ending on the date of the distribution,

(C) such trade or business was not acquired within the period described in subparagraph

(B) in a transaction in which gain or loss was recognized in whole or in part, and

(D) control of a corporation which (at the time of acquisition of control) was conducting such trade or business—

(i) was not acquired directly (or through one or more corporations) by another corporation within the period described in subparagraph (B), or

(ii) was so acquired by another corporation within such period, but such control was so acquired only by reason of transactions in which gain or loss was not recognized in whole or in part, or only by reason of such transactions combined with acquisitions before the beginning of such period.

U.S. GOVERNMENT PRINTING OFFICE: 1967

In the Supreme Court
OF THE
United States

October Term, 1967

No. 781

Oscar E. Baan and Evelyn K. Baan,
Petitioners,
vs.
Commissioner of Internal Revenue,
Respondent.

PETITION FOR A WRIT OF CERTIORARI to the United States Court of Appeals for the Ninth Circuit

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Oscar E. Baan and Evelyn K. Baan, *Petitioners,* vs. Commissioner of Internal Revenue, *Respondent.*	

PETITION FOR A WRIT OF CERTIORARI to the United States Court of Appeals for the Ninth Circuit

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Oscar E. Baan and Evelyn K. Baan pray that a writ of certiorari issue to review a reversal of the judgment of the Tax Court of the United States by the United States Court of Appeals for the Ninth Circuit, in a judgment which directly conflicts with that of the Court of Appeals for the Second Circuit.

OPINIONS BELOW

The Findings of Fact and Opinion of the Tax Court (I-R 79-127)[1], printed in Appendix B, infra, pages 6 to 49, are reported at 45 T.C. 71. The opinion of the Court of Appeals for the Ninth Circuit (I-R), printed in Appendix C, infra, pages 50 to 75, has not yet been officially reported, but is unofficially reported at CCH Fed. Tax Serv. (U.S. Tax Cases) par. 9556, and at 20 A.F.T.R. 2d (P-H) 5268. The opinion of the Court of Appeals for the Second Circuit, printed in Appendix E, infra, pages 77 to 109, is not yet officially reported, but is unofficially reported at CCH Fed. Tax Serv. (U.S. Tax Cases) par. 9592 and at 20 A.F.T.R. 2d (P-H) 5255.

JURISDICTION

The judgment of the Court of Appeals for the Ninth Circuit was filed and recorded on July 7, 1967 (Appx. D, infra, p. 76). Respondent's timely petition for rehearing was denied on August 15, 1967 (I-R). The jurisdiction of this Court is invoked under section 1254(1) of Title 28 of the United States Code, as provided by section 7482(a) of the Internal Revenue Code of 1954 (26 U.S.C. sec. 7482(a) (1964 Ed.)).

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[1]The transcript of the Tax Court hearing comprises Volume Two of the Transcript of Record ("II-R"); the remainder of the record on appeal (except for three volumes of exhibits) is contained in Volume One ("I-R"). Page references are to pages of the Transcript of Record before the Court of Appeals.

QUESTIONS PRESENTED

The Pacific Telephone and Telegraph Company ("Pacific"), by action of its board of directors, approved by its shareholders, adopted a plan of reorganization in 1961, pursuant to which the telephone communications businesses conducted by Pacific in the three States of Oregon, Washington and Idaho were divided from the telephone communications business of Pacific which Pacific continued to conduct in the State of California. Pursuant to this plan, Pacific transferred all of its assets pertaining to its operations in the States of Oregon, Washington and Idaho, to a newly organized corporation, Pacific Northwest Bell Telephone Company ("Northwest"), in exchange for the issuance to Pacific by Northwest of all of Northwest's common stock, a $200,000,000 interest-bearing demand note of Northwest, and the assumption by Northwest of certain operating liabilities of Pacific in these three states. Pursuant to the plan, Pacific issued to all of its shareholders, including petitioners ("taxpayers"), rights represented by short-term transferable stock purchase warrants to purchase all of the common stock of Northwest at a price of $16 per share. Rights to purchase 57 per cent of the Northwest stock were issued by Pacific to its shareholders in 1961, and rights to purchase the remainder of said Northwest stock were issued by Pacific to its shareholders in 1963. Shareholders owning approximately 95 per cent of the shares of Pacific, at the time said plan was adopted, exercised their rights and became shareholders of Northwest. Taxpayers, owners of 600 shares of common stock of Pacific, received 600 rights to purchase Northwest common stock, which rights were exercised by them on October 11, 1961, when the fair

market value of the Northwest stock was $26.94 per share.

The question is presented whether under section 355 of the Internal Revenue Code of 1954 (26 U.S.C. sec. 355 (1964 Ed.)) taxpayers received their stock in Northwest as part of a nontaxable spin-off distribution by Pacific of all the stock of a controlled corporation, as held by the Tax Court and the Court of Appeals for the Second Circuit, contrary to the decision of the Court below.

As an independent reason for reversing the Tax Court, the Ninth Circuit Court of Appeals held as a conclusion of fact that the two transfers of the Northwest stock by Pacific in 1961 and in 1963, pursuant to the plan of reorganization, did not constitute "a single transaction" (Appx. C, infra, pp. 74-75), contrary to the requirements of section 355(a)(1)(D). An additional question is presented whether the Court erred in making this factual determination directly contrary to a finding of fact by the Tax Court, amply supported by the record, and in response to an issue of law raised by respondent for the first time before the Court of Appeals.

STATUTES INVOLVED

The case directly concerns the interpretation of section 355 of the Internal Revenue Code of 1954 (26 U.S.C. sec. 355 (1964 Ed.); 68 A Stat. 113-114)[2] which is set out in Appendix A, infra, pages 1 to 5.

[2]References hereinafter to sections are to sections of the Internal Revenue Code of 1954 (26 U.S.C. (1964 Ed.)) unless otherwise expressly stated.

STATEMENT OF THE CASE

None of the facts found by the Tax Court were disputed by respondent. As the Tax Court found (Appx. B, infra, pp. 6 to 31), petitioners Oscar E. Baan and Evelyn K. Baan, husband and wife and California residents ("taxpayers"), owned through 1961 600 shares of the common stock of The Pacific Telephone and Telegraph Company ("Pacific") (I-R 65), a California corporation engaged since 1907 in furnishing communications services, primarily telephone services, in California. For several decades prior to July 1, 1961, Pacific furnished such services also in Oregon, Washington and a portion of Idaho, but commencing on that date Pacific Northwest Bell Telephone Company ("Northwest"), a Washington corporation, has taken over and furnished such services in those three states (I-R 28). It was stipulated that the businesses Pacific conducted in the three northern states prior to July 1, 1961, were separate from its California business (I-R 40).

American Telephone and Telegraph Company ("American"), a New York corporation, has since 1907 owned about 90 per cent of the voting stock of Pacific (I-R 33), and has since 1961 owned, together with Pacific, about 90 per cent of the capital stock of Northwest (I-R 59). American, Pacific and Northwest are members of the "Bell System" of telephone companies which operates throughout the continental United States and includes 21 telephone company subsidaries of American (I-R 32-33). Pacific has for many years been included in the consolidated Federal income tax returns filed by American. In 1961, this return also included Northwest (I-R 34).

Pacific's issued and outstanding capital stock in 1961 consisted of 104,756,943 shares of common stock with an aggregate par value of $1,496,527,844, and 820,000 shares of 6 per cent cumulative preferred stock with an aggregate par value of $82,000,000 (I-R 29-30). The minority common and preferred shares of Pacific were publicly held by over 38,000 shareholders in 1961. Both the common and preferred shares of Pacific were listed for trading on the New York Stock Exchange and the Pacific Coast Stock Exchange (I-R 33-40).

Between World War II and 1961, Pacific experienced enormous growth in plant investment and operating revenues and in the population served by it. Such growth in the Pacific Coast states was expected to continue. For a number of years prior to 1961, Pacific issued common stock or debentures to obtain an average amount of capital each year of approximately $200,000,000 to meet its capital requirements. Pacific was, in 1961, the eighth largest non-financial company in the United States in terms of total capital (I-R 40-43).

For purely business reasons, because of the enormous and continued growth and extensive operating territory, Pacific decided to divide the corporation between the businesses and assets operated in the States of Oregon, Washington and Idaho, and the business conducted by Pacific in California. Pacific considered a number of methods to effect such division, one of which was to transfer all of the assets in the States of Oregon, Washington and Idaho to a new corporation which would be distributed in a conventional spinoff to Pacific shareholders, without any consideration by them, or the sur-

render by them of the shares of Pacific. Because of obstacles under the corporate law of California, Pacific was prevented from following this method (II-R 27-30). Instead a plan of reorganization was adopted in 1961 by the directors of Pacific and approved by its shareholders, whereby all of Pacific's business and assets in Oregon, Washington and Idaho were transferred to a new corporation, Northwest, for all of the common stock of Northwest, a $200,000,000 promissory note of Northwest, and the assumption by Northwest of certain operating liabilities relating to the assets transferred (I-R 44-45). The capitalization of Northwest was structured to be as similar as possible to that of Pacific (I-R 49-50). Under the plan, all of the Northwest stock was to be offered to the Pacific shareholders through short-term rights. It was left to the discretion of Pacific's management, however, to determine the number of offerings of the Northwest stock and the price at which the stock would be made available. The plan contemplated that these decisions would be based on the capital requirements of Pacific, and that all of the stock of Northwest would be distributed within three years. American intended to exercise all of the rights to which it was entitled, thereby ensuring that on such exercise, when the plan was consummated, American would own more than 80 per cent of the stock of Northwest (Exh. 17-Q).

The Northwest stock was offered to Pacific shareholders in 1961 and 1963 (I-R 52, 58). More than 95 per cent of the Northwest stock was received through the exercise of rights by shareholders who were Pacific shareholders at the time the plan of reorganization was adopted (Exh.

54-BBB). Pacific issued no additional Pacific stock or bonds between 1961 and April, 1964, its entire capital requirements during this period having been satisfied from the proceeds of the Northwest stock (I-R 64).

Taxpayers received, as the holders of 600 shares of common stock of Pacific, 600 rights to acquire Northwest stock. These rights would have expired on October 20, 1961, and were exercised by taxpayers on October 11, 1961. On the date of exercise, the value of the Northwest stock was $26.94 per share, and taxpayers paid $16 for each share of such stock, in the exercise of their rights (I-R 65).

Respondent determined that taxpayers received taxable dividend income under section 301 in the amount of the difference between the value of the Northwest stock on the date of exercise, and the $16 a share paid in exercise of their rights, and consequently determined a deficiency in their 1961 Federal income tax (I-R 18-21). On taxpayers' petition filed pursuant to section 6213 of the Code for redetermination of this deficiency, the Tax Court held that section 355 applied to the receipt of the Northwest stock by taxpayers, that the distribution by Pacific of the Northwest stock under its plan of reorganization constituted a tax-free spinoff under said section, and that no taxable income or gain was recognized thereunder (Appx. B, infra, pp. 35-38).

The Tax Court found it unnecessary to pass on taxpayers' alternative contentions that no gain should be recognized on the ground that the transaction constituted a tax-free exchange under a plan of reorganization under

section 354, or, in the alternative, a distribution in partial liquidation under section 346 (Appx. B, infra, p. 35).

On the Commissioner's petition for review of the Tax Court's decision, the Court of Appeals for the Ninth Circuit reversed the Tax Court and held that section 355 did not apply to the receipt of the Northwest stock by taxpayers. The Court remanded the case to the Tax Court for consideration of taxpayers' alternative arguments (Appx. C, infra, pp. 69, 75).

To review this judgment of reversal, taxpayers have filed this petition for a writ of certiorari.

REASONS FOR GRANTING THE WRIT

1. THE DECISION BELOW IS IN DIRECT CONFLICT WITH THE RECENT SECOND CIRCUIT COURT OF APPEALS DECISION IN THE COMPANION TEST CASE, COMMISSIONER OF INTERNAL REVENUE v. IRVING GORDON AND MARGARET GORDON.

A ruling was issued by the Commissioner of Internal Revenue in 1961 that the non-corporate shareholders of Pacific who exercised their rights to purchase Northwest stock would receive taxable dividend income by reason of such exercise (Exh. 67-000). The income tax returns of a great many of these shareholders for the years 1961 and 1963 are still open for adjustment either on claims for refund or the assertion of deficiencies because of the execution of waivers by such shareholders extending the statute of limitations. To challenge the validity of this ruling of the Commissioner, two test cases were instituted in the Tax Court, one the instant case, and the other the

case of *Irving Gordon and Margaret Gordon v. Commissioner of Internal Revenue.* These two cases were consolidated for trial and opinion in the Tax Court, which ruled in favor of the taxpayers and held that no taxable income resulted under section 355 from the exercise of rights to acquire Northwest stock (Appx. B, infra, p. 35). Respondent filed petitions for review of this case by the Court of Appeals for the Ninth Circuit (I-R 129-131), and of the *Gordon* case by the Court of Appeals for the Second Circuit. The *Gordon* case was decided by the Second Circuit on July 26, 1967, affirming the Tax Court's ruling that section 355 applied (Appx. E, infra, pp. 77-109).

The Second Circuit Court of Appeals disagreed with the Ninth Circuit on certain important aspects of the application of section 355. The Second Circuit ruled directly contrary to the Ninth Circuit that the stock of Northwest had been distributed by Pacific with respect to the Pacific stock, within the meaning of section 355(a)(1)(A) (Appx. E, infra, pp. 88-91). The Second Circuit Court of Appeals also disagreed with the Court below in its holding that the requirements of section 355 were not met for the reason that the two offerings of the Northwest stock to the Pacific shareholders, pursuant to the plan of reorganization, did not constitute a single transaction. The Court of Appeals for the Second Circuit held that the two offerings of the Northwest stock constituted a single distribution and that there was no violation of section 355 even if said section could be construed to require a single distribution (Appx. E, infra, pp. 93-99).

These two decisions therefore are diametrically opposed in the construction and application of essential elements of section 355. Unless conflict between these two Courts of Appeals is resolved, the tax treatment of the exercise of rights for many thousands of Pacific shareholders who exercised their rights in 1961 and 1963 will be uncertain and will inevitably result in widespread litigation unless the issue in this case is resolved by this Court.

It is understood that the Commissioner is concurrently filing a petition for certiorari with this Court to review the *Gordon* case. The taxpayers in that case will not oppose the Commissioner's request for a writ of certiorari.

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2. THE DECISION BELOW PRESENTS A CONFLICT BETWEEN THE COURTS OF APPEALS ON IMPORTANT, CONTINUING QUESTIONS OF LAW WHICH SHOULD BE SET AT REST BY THIS COURT.

The issue in this case involves novel questions in the interpretation and application of section 355. If the Northwest stock had been distributed by Pacific to its shareholders without the payment of cash by the Pacific shareholders, with or without the surrender by them of Pacific stock, the transaction would have qualified as a classic divisive reorganization to which the non-recognition provisions of section 355 are specifically addressed, and no taxable gain would be recognized by the Pacific shareholders on the receipt of the Northwest stock (Appx. B, infra, pp. 36-38). The Tax Court found it inconceivable that Congress could have intended, under section 355, that the same receipt of Northwest stock by the

Pacific shareholders would involve a tax, where the recipient Pacific shareholders were required to contribute to the capital of Pacific as a condition to receiving the Northwest stock (Appx. B, infra, p. 40). The Second Circuit agreed with the Tax Court that, where the Pacific shareholders could have received the Northwest stock tax-free without the payment of any consideration, the payment by them of $16 per share for Northwest stock as a contribution to the capital of Pacific should not provide an occasion for the imposition of a tax (Appx. E, infra, p. 88). There is no decided case under section 355 or its predecessor provisions under the Internal Revenue Code of 1939 dealing with the situation where cash is paid in by the shareholders to receive stock of the corporation being distributed in a spinoff transaction. The other questions of whether section 355 admits of two distributions and what is necessary to satisfy this requirement if it is present in section 355 are equally novel and important.

Section 355 (Appx. A, infra, pp. 1-5) is a comprehensive statute designed to deal in one section with all the divisive corporate reorganizations, whether they take the form of split-offs, split-ups or spinoffs.[3] That section

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[3]The Court below distinguished these reorganizations as follows (Appx. C, infra, p. 60, n. 9):

> "A split-off involves the same kind of transaction as a spin-off except that the shareholders surrender part of their stock in the parent corporation in exchange for stock in the subsidiary. In a split-up, the parent corporation transfers substantially all its assets to two or more corporations and then liquidates, its stockholders surrendering all their stock in the transferor and receiving the stock in the transferee corporations. See Note, *Tax Treatment of Corporate Divisions*, 52 Colum. L. Rev. 408, 409 (1952); Mintz, *Divisive Corporate Reorganizations: Split-Ups and Split-Offs*, 6 Tax L. Rev., 365 (1951)."

was the embodiment of a Congressional policy that corporate divisions were desirable in the public interest and should not be impeded by tax considerations (Appx. E, infra, p. 85).

Unless the questions relating to the interpretation of section 355 are decided in this case and in the *Gordon* case, these important questions of interpretation of section 355 will remain unresolved. The magniture of corporate reorganizations and their tax effect on shareholders which may arise under section 355 may well be gauged by examining the situation presented here. In this case, the Pacific Company distributed 30,000,000 shares of Northwest stock, and the amount paid into Pacific in the exercise of rights was in excess of a half billion dollars (I-R 54, 59). Pacific had over 38,000 shareholders, and the income tax liability of some 25,000 shareholders will be directly affected by the outcome of these cases (I-R 33; Exh. 54-BBB). A clear understanding of the tax effect of corporate adjustments under section 355 is essential for the administration of the revenue laws and the carrying out of such transactions. Review by this Court in this case is necessary to remove these conflicts and uncertainties now present in this important area of the operation of the income tax laws.

3. THE DECISION BELOW IS PREDICATED ON A CONCEPT OF THE NATURE OF STOCK RIGHTS FOR TAX PURPOSES WHICH IS DIRECTLY CONTRARY TO THE DECISION OF THIS COURT IN THE LANDMARK CASE OF PALMER v. COMMISSIONER (1937) 302 U.S. 63.

In the *Palmer* case, the Supreme Court resolved a conflict which had existed among the Courts of Appeals as to the tax effect of the issuance of stock rights by a corporation. The lower courts were divided as to whether a dividend resulted when a corporation issued or distributed stock rights, or when the shareholders exercised their rights. In holding that if a dividend resulted from exercise of rights, the taxable event was the exercise of the rights, the Supreme Court held in the *Palmer* case that the mere issuance of rights to subscribe and their receipt by shareholders is not a dividend, and that no distribution of corporate property results except upon exercise. Rights are mere options which do not effect a distribution of corporate property until they are exercised. This was the view taken both by the Tax Court and Second Circuit Court of Appeals in the *Gordon* case with respect to the Northwest stock rights received and exercised by taxpayers. Both Courts held that there was no distribution of corporate property until the rights were exercised, and that the subject of the distribution by Pacific was not the rights but rather the Northwest stock received on exercise (Appxs. B and E, infra, pp. 40-41, 89).

The decision below reflects a fundamental misconception of the nature and tax treatment of stock rights issued by a corporation to its shareholders, as delineated by the decision of this Court in the *Palmer* case. The

Court below held that section 301 was applicable to the "distribution" received by taxpayers from Pacific. The Court's opinion shows clearly that it considered that the subject of the distribution was the Northwest rights rather than the Northwest stock. The Court stated in its opinion (Appx. C, infra, p. 63) as follows: "Pacific's distribution of stock rights 'with respect to its stock' logically constitutes the distribution of property within the meaning of section 301." If this decision is allowed to stand, confusion and uncertainties as to the tax treatment of stock rights will result from the improper application by the Court below of the rule of the *Palmer* case.

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4. THE COURT BELOW IMPROPERLY RESTED ITS DECISION ON A FACTUAL DETERMINATION, DIRECTLY CONTRARY TO A FINDING OF FACT BY THE TAX COURT AMPLY SUPPORTED BY THE RECORD, AND IN RESPONSE TO A NEW ISSUE OF LAW RAISED BY RESPONDENT FOR THE FIRST TIME BEFORE THE COURT OF APPEALS. IN SO DOING, THE COURT BELOW HAS SO DEPARTED FROM THE ACCEPTED COURSE OF JUDICIAL PROCEEDINGS AS TO REQUIRE THE EXERCISE BY THIS COURT OF ITS SUPERVISORY JURISDICTION.

As an independent reason for reversal, the Court held that Pacific did not distribute control of Northwest in a single distribution as required by section 355(a)(1)(D) (Appx. C, infra, p. 69). This contention was made by respondent for the first time before the Court of Appeals. In the Tax Court the respondent did not contend that section 355 was not satisfied because of the two offerings of Northwest rights by Pacific to its shareholders in 1961 and 1963. There was no dispute between petitioners and

respondent, and the Tax Court found that the two offerings were component parts of a single plan and that they must be regarded together as resulting in the disposition of 100 per cent of the Northwest stock in a single transaction (Appx. B, infra, p. 33, n. 4). Nonetheless, respondent contended before the Court of Appeals that section 355(a)(1)(D) as a matter of law required a single distribution as of a single date, and that the offerings of the Northwest stock in 1961 and 1963 were contrary to this requirement of section 355.

The Court below considered this argument on its merits even though advanced for the first time on review, but did so on the ground that it raised a point of law (Appx. C, infra, p. 69). Although the Court rejected respondent's legal contention that section 355 required a single distribution, the Court went on to examine the record and make a finding of fact directly contrary to that found by the Tax Court (Appx. C, infra, pp. 71, 74-75). The Court of Appeals found that the two distributions of Northwest stock in 1961 and 1963 did not constitute a single transaction, and in so doing the Court below departed from the well-established rule laid down by this Court that factual determinations are to be left to the trial court (*Commissioner v. Duberstein* (1960) 363 U.S. 278).

The record amply supported the Tax Court's determination that the two offerings by Pacific in 1961 and 1963 were component parts of a single plan which resulted in the disposition of all of the Northwest stock in a single transaction (see, e.g., Exh. 17-Q, pp. 8, 11; II-R 46). The factual determination by the Court below to the

contrary in response to an argument of law raised by respondent for the first time on appeal was an improper exercise by that Court of its appellate jurisdiction which should be corrected by this Court.

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,
Harry R. Horrow,
Stephen J. Martin,
Attorneys for Petitioners.

Pillsbury, Madison & Sutro,
Of Counsel.

(Appendices Follow)

Index to Appendices

Appendix A

INTERNAL REVENUE CODE OF 1954
(26 U.S.C. (1964 Ed.)):

Sec. 355. Distribution of Stock and Securities of a Controlled Corporation.

(a) Effect on Distributees.—

(1) General rule.—If—

(A) a corporation (referred to in this section as the "distributing corporation")—

(i) distributes to a shareholder, with respect to its stock, or

(ii) distributes to a security holder, in exchange for its securities, solely stock or securities of a corporation (referred to in this section as "controlled corporation") which it controls immediately before the distribution,

(B) the transaction was not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both (but the mere fact that subsequent to the distribution stock or securities in one or more of such corporations are sold or exchanged by all or some of the distributees (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device),

(C) the requirements of subsection (b) (relating to active businesses) are satisfied, and

(D) as part of the distribution, the distributing corporation distributes—

(i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or

(ii) an amount of stock in the controlled corporation constituting control within the meaning of section 368(c), and it is established to the satisfaction of the Secretary or his delegate that the retention by the distributing corporation of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax,

then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder or security holder on the receipt of such stock or securities.

(2) NON PRO RATA DISTRIBUTIONS, ETC.—Paragraph (1) shall be applied without regard to the following:

(A) whether or not the distribution is pro rata with respect to all of the shareholders of the distributing corporation,

(B) whether or not the shareholder surrenders stock in the distributing corporation, and

(C) whether or not the distribution is in pursuance of a plan of reorganization (within the meaning of section 368(a)(1)(D)).

(3) Limitation.—Paragraph (1) shall not apply if—

(A) the principal amount of the securities in the controlled corporation which are received exceeds the principal amount of the securities which are surrendered in connection with such distribution, or

(B) securities in the controlled corporation are received and no securities are surrendered in connection with such distribution.

For purposes of this section (other than paragraph (1) (D) of this subsection) and so much of section 356 as relates to this section, stock of a controlled corporation acquired by the distributing corporation by reason of any transaction which occurs within 5 years of the distribution of such stock and in which gain or loss was recognized in whole or in part, shall not be treated as stock of such controlled corporation, but as other property.

(4) Cross reference.—

For treatment of the distribution if any property is received which is not permitted to be received under this subsection (including an excess principal amount of securities received over securities surrendered), see section 356.

(b) Requirements as to Active Business.—

(1) In general.—Subsection (a) shall apply only if either—

(A) the distributing corporation, and the controlled corporation (or, if stock of more than one

controlled corporation is distributed, each of such corporations), is engaged immediately after the distribution in the active conduct of a trade or business, or

(B) immediately before the distribution, the distributing corporation had no assets other than stock or securities in the controlled corporations and each of the controlled corporations is engaged immediately after the distribution in the active conduct of a trade or business.

(2) DEFINITION.—For purposes of paragraph (1), a corporation shall be treated as engaged in the active conduct of a trade or business if and only if—

(A) it is engaged in the active conduct of a trade or business, or substantially all of its assets consist of stock and securities of a corporation controlled by it (immediately after the distribution) which is so engaged,

(B) such trade or business has been actively conducted throughout the 5-year period ending on the date of the distribution,

(C) such trade or business was not acquired within the period described in subparagraph (B) in a transaction in which gain or loss was recognized in whole or in part, and

(D) control of a corporation which (at the time of acquisition of control) was conducting such trade or business—

(i) was not acquired directly (or through one or more corporations) by another corporation within the period described in subparagraph (B), or

(ii) was so acquired by another corporation within such period, but such control was so acquired only by reason of transactions in which gain or loss was not recognized in whole or in part, or only by reason of such transactions combined with acquisitions before the beginning of such period.

Appendix B

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45 T. C. No. 5

TAX COURT OF THE UNITED STATES

Oscar E. Baan and Evelyn K. Baan, Petitioners, *v.* Commissioner of Internal Revenue, Respondent.

Irving Gordon and Margaret Gordon, Petitioners, *v.* Commissioner of Internal Revenue, Respondent.

Docket Nos. 949-63, 3949-63. Filed October 19, 1965.

Pacific corporation was engaged in the telephone business in California and other western states. It transferred to Northwest, a newly created subsidiary, the assets used in the telephone business conducted in Oregon, Washington and Idaho. It thus became the owner of all of the Northwest stock which it subsequently distributed through the medium of short-term rights issued to its stockholders. *Held,* the transaction was a tax-free spin-off under Section 355, I.R.C. 1954, and petitioner-stockholders who obtained Northwest stock by exercising their rights did not thereby realize taxable income at that time. *Held further,* amounts realized by a shareholder of Pacific upon a sale of his rights to purchase Northwest stock are taxable as dividend income.

Harry R. Horrow and *Stephen J. Martin,* for the petitioners.

John W. Holt, for the respondent.

The Commissioner determined deficiencies against petitioners in Federal income taxes for 1961 in the following amounts:

Oscar E. and Evelyn K. Baan	$284.44
Irving and Margaret Gordon	895.10[1]

The principal question presented in these cases is whether petitioners received taxable dividends upon the exercise of rights issued to them by the Pacific Telephone and Telegraph Company enabling petitioners to purchase shares of its wholly-owned subsidiary, Pacific Northwest Bell Telephone Company. Also at issue is the tax treatment to be given to the amounts realized by petitioners in Docket No. 3949-63 upon the sale of four of the rights received by them.

FINDINGS OF FACT

The stipulation of facts filed by the parties together with the exhibits attached thereto is incorporated herein by this reference.

Petitioners Oscar E. Baan and Evelyn K. Baan, husband and wife, were residents of Sausalito, California, during 1961; they filed their joint Federal income tax return for the calendar year 1961 on the cash basis with the district director of internal revenue in San Francisco, California.

Petitioners Irving Gordon and Margaret Gordon, husband and wife, were residents of New York City during 1961; they filed their joint Federal income tax return for the calendar year 1961 on the cash basis with the district director of internal revenue in New York City.

At all times during 1961, the Baans owned 600, and the Gordons owned 1,540, shares of common stock of

[1]Petitioners Gordon paid this amount subsequent to the filing of the petition in this case.

Pacific Telephone and Telegraph Company, which had been purchased by them at various times prior to 1961.

The Pacific Telephone and Telegraph Company (hereinafter referred to as "Pacific") is a California corporation which furnishes communications services, mainly local and long-distance (toll) telephone services, in the State of California. Prior to July 1, 1961, it furnished such services also in the States of Oregon, Washington and a northern portion of Idaho.

Pacific Northwest Bell Telephone Company (hereinafter referred to as "Northwest"), a Washington corporation, has commencing on July 1, 1961, furnished such services in the territory previously served by Pacific in Oregon, Washington and Idaho. Bell Telephone Company of Nevada (hereinafter referred to as "Nevada"), a wholly owned subsidiary of Pacific, furnishes such services in Nevada.

Revenues from telephone services constitute approximately 90 percent of the total operating revenues of the three corporations. Other communications services furnished include teletypewriter services, and services and facilities for private-line teletypewriter use, for the transmission of radio and television programs and for other purposes. Revenues are also received from the sale of advertising space in telephone directories.

In each state in which it operates, each of the three corporations is subject to regulation by a state public utility regulatory authority which has power within its jurisdiction to regulate intrastate rates, services and other matters, including but not limited to some or all

of the following: facilities, security issues, valuations, purchases and sales of property, budgets, the assessment of fees for the expenses of such authorities, and contracts and other relations with affiliated corporations. All three corporations are likewise subject to regulation by the Federal Communications Commission with respect to their method of accounting and to interstate rates, lines and services, valuations and other matters. The Federal Communications Commission prescribes a Uniform System of Accounts which it requires telephone companies to use in keeping their books.

American Telephone and Telegraph Company (hereinafter referred to as "American"), a New York corporation, has owned more than 80 percent of the voting stock of Pacific at all times since 1907. Including Pacific, Northwest and Nevada, there were 21 operating telephone company subsidiaries of American in 1961. Of these operating subsidiaries American owns substantially 100 percent of 15 of them.[2] American owns the following percentages of the outstanding stock of its remaining subsidiaries:

Company	Percent Owned
Illinois Bell Telephone Co.	99.32
Pacific*	89.62
Northwest	89.13
The Mountain States Telephone and Telegraph Co.	86.75
New England Telephone and Telegraph Co.	69.33

*Pacific owns 100 percent of Nevada.

[2]In two of these companies a small number of directors' qualifying shares are privately held. [The official report (45 T.C. 71) numbered this as footnote 1, and numbered all subsequent footnotes one number lower.]

American operates a network of cable, wire and radio circuits and related equipment for intercommunication between and through the territories of its telephone subsidiaries and of other telephone companies and for interconnection (including interconnection by underseas cables and by radio circuits) between telephone systems in the United States and those in many other countries or territories throughout the world.

American's telephone subsidiaries, including Pacific and Northwest, furnish local and toll service in the territories in which they operate and toll service between points within and points outside of such territories, toll service being furnished partly in conjunction with American and other telephone companies. American's subsidiaries operate in the District of Columbia and in every state except Alaska and Hawaii. American estimates that over 90 percent of the toll messages originating in the United States are routed in whole or in part over its lines or those of its subsidiaries.

During all of the year 1961 the capital stock of Pacific consisted of the following:

(a) 820,000 shares of 6 percent cumulative preferred stock authorized with a par value of $100 per share, entitled to 7 votes per share held, of which stock all 820,000 shares were issued and outstanding, with an aggregate par value of $82,000,000; and

(b) 105,000,000 shares of common stock authorized with a par value of $14-2/7 per share, entitled to one vote per share held, of which stock 104,756,943 shares were issued and outstanding, with an aggregate par value of $1,496,527,844.

As of December 31, 1960, Pacific had unappropriated earned surplus in the amount of $192,053,880.76. As of December 31, 1961, Pacific had $178,935,190.15 of unappropriated earned surplus and a capital surplus of $101,-326,128.38. There was a sufficient dollar amount of earnings and profits of Pacific in 1961 from which a 1961 dividend could have been paid by Pacific to its stockholders, to cover the dollar amounts which the Commissioner contends were received by the petitioners in these cases and by the other shareholders of Pacific in 1961 with respect to the distribution of Northwest stock. At all times during 1961, Pacific's long-term funded debt was $902,000,000.

Pacific has from time to time carried out its temporary financing by means of advances from American. These loans are evidenced by demand notes due one day after date of issuance, which bear interest at 4-½ percent per annum. Normally, Pacific discharges such advances through the use of the proceeds from its issuance and sale of its common stock and long-term debentures. The year end balance of such advances on Pacific's books and records, in millions of dollars, for the years 1956 through 1963 were as follows:

Year	Year End Balance
1956	$ 56
1957	82
1958	11
1959	161
1960	134
1961*	-0-
1962	140
1963	49

*As of June 30, 1961 advances outstanding amounted to $233,000,000.

American at all times during 1961 owned 90.25 percent of the outstanding common stock and 78.17 percent of the outstanding preferred stock of Pacific, representing in the aggregate 89.62 percent of the total voting power of Pacific.

The minority common and preferred shares of Pacific are publicly held. At the time of Pacific's annual shareholders' meeting in 1961 it had over 38,000 shareholders. For several years prior to 1961, during all of 1961, and at all times since 1961 the common shares and preferred shares of Pacific have been listed for trading on the New York Stock Exchange and the Pacific Coast Stock Exchange.

Commencing with the year 1907, Pacific has employed the calendar year as its accounting year and has kept its books of account to the extent permitted by law on the basis of the accrual method of accounting. Commencing with the year 1914, Pacific has filed its Federal income tax returns on the basis of the calendar year and to the extent permitted by law on the basis of the accrual method of accounting. Since January 1, 1913, Pacific has maintained its accounts in accordance with the Uniform System of Accounts for telephone companies prescribed originally by the Interstate Commerce Commission and since July 1934 by the Federal Communications Commission. For the taxable years 1924 through 1931, Pacific filed, as the parent corporation, consolidated Federal income tax returns with its own subsidiaries. For the taxable years 1932 through 1953, Pacific filed separate corporate Federal income tax returns. For the taxable years 1954 through 1962, Pacific was included as an af-

filiated subsidiary in the consolidated Federal income tax return of American. Commencing with the taxable year 1961, this consolidated Federal income tax return, with American as the parent corporation, included and was filed in behalf of Northwest as well as the other affiliated corporations. In none of the consolidated Federal income tax returns of American and its affiliates for the taxable years 1954 through 1962 did the members of the affiliated group elect, as permitted under Section 1.1502-31(b)(1) of the Income Tax Regulations, to take into account in the computation of consolidated taxable income the gains and losses reflected in certain intercompany transactions.

The parties have stipulated that "for more than five years prior to June 30, 1961, the operations of Pacific in the States of Oregon, Washington and a northern portion of Idaho, constituted one or more telephone communications businesses operated by Pacific which were separable from the telephone communications business operated by Pacific in the State of California". At all times after June 30, 1961, Pacific has continued in the operation of the telephone communications business in California, and Northwest has engaged in the operation of that business in Oregon, Washington and part of Idaho.

Between the end of World War II and January 1, 1961, there was a substantial increase in the demand for telephone service in the area served by Pacific. The number of telephones increased almost threefold from 2,700,000 to about 8,000,000. The investment in telephone plant (without deducting the depreciation reserve) increased more than fivefold from $662,000,000 to $3,402,000,000; and annual operating revenues increased more than four-

fold from $243,000,000 to $1,120,000,000. The operations of Pacific in the single State of California in 1960, in terms of plant investment and operating revenues, exceeded those of the entire company in California, Oregon, Washington and Idaho in 1957, and the operations of Pacific in Oregon, Washington and Idaho in 1960 almost equalled those for the entire company at the end of World War II. Growth in all the Pacific Coast states was continuing in 1961 at a rapid pace. Recent studies had predicted the population of California would increase from about 16,100,000 at the end of 1960 to more than 20,000,000 in 1970. Large population increases were also expected in the other states in which Pacific did business.

In terms of total capital, Pacific at the end of 1960 was the largest subsidiary corporation in the Bell System and the eighth largest non-financial company in the nation. On the same basis Northwest, as of July 1, 1961, was larger than eight and smaller than twelve of the other Bell System subsidiaries. It was the largest public service company in the Pacific Northwest area.

John O. Einerman, formerly an officer of American, has been vice president and comptroller of Pacific since March, 1958. Shortly after he joined Pacific Einerman was asked by the president of the company to undertake studies looking toward the division of Pacific into two or three separate companies. The basic problem which brought forth the need for such studies was understood by Einerman to be the tremendous growth of the telephone system on the Pacific Coast and the fact that the territory covered by Pacific encompassed about one-seventh of the continental United States. He worked with

a small group of people within the company and the company's lawyers considering various plans which were developed within this group. That group analyzed the financial impact of the various procedures that they considered. Einerman concluded that the studies showed that it would be extremely desirable from an operating point of view to divide Pacific into two separate corporations. As a result of the studies Pacific was divided into two separate divisions in 1960 and was then divided into two separate corporations in 1961.

In a meeting on January 27, 1961, the board of directors of Pacific resolved to submit to the shareholders of Pacific a plan entitled "Plan For Reorganization of The Pacific Telephone and Telegraph Company" (hereinafter referred to as the "Plan") for consideration at the annual meeting of the shareholders on March 24, 1961. At the request of the chairman, Einerman addressed Pacific's board of directors and explained the need for and purposes of the Plan, prior to the vote on the pertinent resolutions.

The reasons given for dividing the operations of Pacific were the size of the area served by the company (about one-seventh of the area of the mainland states); the rapid growth of the population of the area since World War II with increases in the number of telephones, and the amount of plant investment and operating revenues; and the expected continued growth of the population of the area with a continuing increase in the amount of telephone service required.

The advantages of having a separate division which had been set up in 1960 to run the operations of Pacific in

Oregon, Washington and Idaho were considered by management to be as follows:

1. Top authority closer to communities served.
2. Better recognition of service needs of each community.
3. More flexibility in dealing with customers.
4. Closer relations with employees.
5. Better understanding by public and authorities.
6. More efficient operations.

In addition, the following advantages were expected to be gained by the establishment of the Northwest Division as a separate corporation:

1. Financing problems, as well as operating problems, would be assumed by Pacific-Northwest management.

2. A board of directors with final authority, drawn from the territory served, would replace the then-existing advisory boards.

3. The Pacific Company management would be able to concentrate full attention to the needs of California and Nevada.

Under the terms of the Plan, the board of directors of Pacific was to cause a "New Company" to be incorporated under the laws of the State of Washington. The Plan further provided that:

> 3. The Pacific Company shall transfer to the New Company all of the business and properties of the Pacific Company located in the States of Oregon, Washington and Idaho, including all property, whether real or personal, tangible or intangible, fran-

chises, easements, rights-of-way, licenses, leases and all rights of any nature, whether existing or contingent at the time of transfer, arising out of or in connection with its business in the States of Oregon, Washington and Idaho, all of the foregoing being transferred in consideration for (i) the assumption by the New Company of all liabilities, whether existing or contingent at the time of transfer, of the Pacific Company relating to the business of the Pacific Company in such states, except liabilities with respect to any dividends declared on stock, income taxes for which liability reserves have been established and principal of and interest on the debentures and short term debt of the Pacific Company, and (ii) capital stock and debt obligations of the New Company in a total amount which will bear substantially the same relationship to the net book cost of the assets transferred and liabilities assumed as the total of the par value of the stock (common and preferred) and the aggregate principal amount of the debt obligations of the Pacific Company bears to the net book cost of all its assets less liabilities prior to said transfer, the par value of capital stock, debt obligations and surplus of the New Company to be in substantially the same proportions as the par value of stock (common and preferred), debt obligations and surplus of the Pacific Company prior to said transfer.

4. The Pacific Company shall offer to its shareholders as set forth below the right to purchase all of the shares of capital stock of the New Company acquired pursuant to this Plan. The number of shares to be offered to the shareholders of the Pacific Company in any one offering, the number of offerings to be made, and the price at which said shares shall be offered to the shareholders of the Pacific Company

shall be determined by the Board of Directors of the Pacific Company in its sole discretion, provided, however, that each offering shall be made to the shareholders of the Pacific Company on the following basis:

a. The holders of record, on such date as may be specified by the Board of Directors of the Pacific Company, of the common shares of the Pacific Company will receive rights to purchase stock of the New Company on the basis of a prorate offering entirely to such holders, subject to the following provisions. The holders of record, on such date, of the preferred shares of the Pacific Company other than American Telephone and Telegraph Company will receive rights to purchase such stock on the basis that each such holder of preferred shares, for each preferred share held, will receive seven times the number of rights to purchase stock of the New Company that holders of common shares will receive for each common share held. The rights to participate received by such holders of preferred shares will come from rights which American Telephone and Telegraph Company would otherwise receive with respect to its common shares.

b. In connection with the final offering of the shares of stock of the New Company, shares not sold upon the exercise of rights may be sold by the Pacific Company to American Telephone and Telegraph Company.

The sale of the Northwest stock through the issuance of rights to the shareholders of Pacific pursuant to the Plan was intended to serve the purpose of providing Pacific with additional capital funds required by Pacific for future operations in California. In each of the seven 12-month periods ended June 30, 1960, Pacific issued ad-

ditional common stock and/or long-term debentures. The proceeds from the sale of those securities, net of expenses and premiums, were $1,313,750,000, or an average for each of the seven years 1954-1960 of $187,678,600. In the 36-month period from July 1, 1960, through June 30, 1963, Pacific did not issue any additional common stock or debentures.

Before adopting the Plan, the management of Pacific considered various alternative proposals concerning the distribution of the Northwest shares. One such proposal was the distribution of the Northwest shares to the shareholders of Pacific without the payment by them of any consideration. This was dropped because Pacific's management was advised by its attorneys that it would be required to charge such a distribution to earned surplus, and it had insufficient surplus for this purpose. Pacific's management was advised that it could create a reduction surplus out of capital against which a distribution of the shares of Northwest could be charged, but such a reduction surplus would be required under California law to be used first to redeem all of the preferred shares of Pacific. Pacific's management was advised and believed, although possibly erroneously, that under California law Pacific's preferred shares were not subject to redemption. In addition, the desire of Pacific to raise new capital from the distribution of the Northwest shares would not have been fulfilled by such a method.

On March 24, 1961, a meeting of the shareholders of Pacific was held at which the Plan was approved and adopted, subject to consent and approval by the Federal Communications Commission and the public utility regu-

latory authorities in each of the States of Oregon, Washington and Idaho. At that meeting, Einerman addressed the shareholders regarding the Plan, setting forth substantially the same material that he had presented at the directors' meeting.

Pursuant to the Plan, Northwest was organized under the laws of the State of Washington on March 27, 1961, with an authorized capital stock consisting of 50,000,000 shares of one class common stock with a par value per share of $11. On March 28, 1961, 10,000 shares of such stock were issued by Northwest to Pacific upon the payment by Pacific of $110,000 in cash.

On March 31, 1961, Pacific and Northwest submitted to the Public Utilities Commissioner of Oregon a joint application for an order authorizing Pacific to sell and Northwest to purchase the business and properties of Pacific in the State of Oregon and for certain related orders. On the same date, Pacific and Northwest submitted to the Washington Public Service Commission a joint application for an order authorizing Pacific to sell and Northwest to purchase the business and properties of Pacific in the State of Washington and authorizing the issuance of common stock and debt obligations of Northwest and the acquisition thereof by Pacific. On the same date, Pacific and Northwest submitted to the Idaho Public Utilities Commission a joint application of Pacific to withdraw its tariffs from Idaho and of Northwest to file tariffs with the Commission for Idaho. On April 3, 1961, Pacific and Northwest filed with the Federal Communications Commission a joint application for a certificate to the effect that the present and future public convenience and neces-

sity required the acquisition and operation by Northwest of the interstate toll lines of Pacific located in the States of Oregon, Washington and Idaho, and for a certificate to the effect that neither the present nor future public convenience and necessity would be adversely affected by the discontinuance of interstate telephone and telegraph services by Pacific over the lines to be acquired by Northwest.

On May 15, 1961, the Idaho Public Utilities Commission issued its approval order; on June 5, 1961, the Washington Public Service Commission issued its order granting its approval; on June 12, 1961, the Public Utilities Commissioner of Oregon issued his order granting his approval; and, on June 15, 1961, the Federal Communications Commission issued its approval order and certificate.

At a meeting of the board of directors of Pacific on June 30, 1961, the transfer of assets from Pacific to Northwest as contemplated by the Plan was approved. As of 11:59 p.m. on June 30, 1961, all of the business and properties of Pacific in the States of Oregon, Washington and Idaho were transferred to Northwest in consideration for:

(a) the assumption by Northwest of outstanding liabilities relating to the operations of Pacific in such states, with the exception of liabilities with respect to dividends declared on stock, income taxes for which liability reserves had been established and principal of and interest on debentures and short-term debt of Pacific;

(b) the issuance to Pacific by Northwest of a promissory note payable on demand in the principal

amount of $200,000,000 bearing interest at the rate of 4½ per cent per annum; and

(c) the issuance to Pacific by Northwest of an additional 30,450,000 shares of its $11 par value common stock, having an aggregate par value of $334,-950,000.

As contemplated by the Plan, as of the close of business on June 30, 1961, Pacific ceased operation of the business in the States of Oregon, Washington and Idaho, and as of July 1, 1961, Northwest commenced operation of the business received from Pacific in the States of Oregon, Washington and Idaho.

The par value of stock, aggregate debt (including advances from American evidenced by promissory notes due one day after issue), surplus per books and net book cost of assets less liabilities (a) of Pacific immediately prior to the above-mentioned transfer and (b) of Northwest as of commencement of business on July 1, 1961, were as follows:

	(a) Pacific		(b) Northwest	
	Amount	Percent	Amount	Percent
Stock	$1,578,527,844	54.0	$335,060,000	58.0
Debt:				
Funded	902,000,000			
Advances from American	233,000,000			
Demand note			200,000,000	
Total debt		38.9		34.7
Surplus	207,043,321*	7.1	41,986,477**	7.3
Total Capitalization***	$2,920,571,165	100.0	$577,046,477	100.0

*Before reduction by retroactive depreciation adjustment.
**Before reduction by retroactive depreciation adjustment and by capital stock expense.
***Equal to net book cost of assets less liabilities.

The total capitalization of Northwest was arranged in such a way as to maintain substantially the same ratios of stock, aggregate debt and surplus as those of Pacific as set forth above. The proximate aggregate par value of capital stock of Northwest to be outstanding having been thus determined, the $11 par value per common share and the approximate number of common shares of Northwest to be outstanding were determined by March 27, 1961, the date of incorporation of Northwest. The $11 par was selected, after review of the normal relationship between par value and market price of the common shares of Pacific's stock, with a view to a price range for the common shares of Northwest's stock which would be most attractive to investors. It was believed that the relationship between the price range at which the Northwest stock would be traded on the exchange and the book value of the Northwest stock would be approximately equal to the relationship between the price range at which the Pacific common stock would be traded and the book value of the Pacific common stock, such future price range of Pacific common stock being forecast in the light of the current prices of Pacific common stock.

On the 1961 consolidated income tax return filed by American and its subsidiaries the transfer of assets from Pacific to Northwest was treated as a transaction coming under Section 351. It was reported that Pacific received from Northwest 30,450,000 shares of Northwest common stock; no securities of Northwest; no money; and other property in the form of a $200,000,000 demand note of Northwest. Since both Pacific and Northwest were included in a consolidated return in the year of the transfer, no gain or loss was reported on the transaction.

From March 28, 1961, until September 29, 1961, Pacific was the sole shareholder of Northwest. Pursuant to the Plan, on September 29, 1961, Pacific issued to its shareholders rights, evidenced by assignable warrants, to purchase 17,459,490 shares of the common stock of Northwest, constituting approximately 57.3 percent of the total outstanding common shares of Northwest.

In conformance with the provisions of paragraph 4(a) of the Plan, each minority common shareholder of Pacific of record at the close of business on September 20, 1961, was issued one right for each common share of Pacific so held. The number of common shares of Pacific so held by minority shareholders was 10,214,804. At the close of business on September 20, 1961, American held 94,542,139 shares of common stock and 640,957 shares of preferred stock of Pacific. Under the Plan, 1,253,301 rights were received by the minority preferred shareholders of Pacific on the basis of seven rights for each preferred share of Pacific held by them. These 1,253,301 rights came from rights which American would otherwise have received with respect to its common shares of Pacific, on the basis of one right for each common share of Pacific which American held. Consequently, American received on September 29, 1961, 93,288,838 rights with respect to its 94,542,139 common shares of Pacific. American received no rights with respect to its preferred shares of Pacific.

Under the terms of the offering, six rights and the payment of $16 were required for the purchase of each share of common stock of Northwest. The rights were required to be exercised no later than October 20, 1961.

The common stock of Northwest was listed on the American Stock Exchange and on the Pacific Coast Stock Exchange, and trading with respect to the shares of such stock commenced on September 14, 1961, on a when-issued basis. The rights issued by Pacific on September 29, 1961, were admitted to trading on the American Stock Exchange and on the Pacific Coast Stock Exchange and trading with respect to said rights commenced on September 14, 1961, on a when-issued basis.

Petitioners Baan exercised all of the 600 rights issued to them which entitled them to acquire 100 shares of common stock of Northwest and paid to Pacific $1,600 in cash ($16 per share) on October 11, 1961. Petitioners Gordon exercised 1,536 of the 1,540 rights issued to them which entitled them to acquire 256 shares of common stock of Northwest and paid to Pacific $4,096 in cash ($16 per share) on October 5, 1961. On October 5, 1961, petitioners Gordon sold the four rights to purchase Northwest stock which they had received from Pacific but did not exercise. The net proceeds from the sale of the four rights were $6.36.

The fair market values on selected dates of Pacific common and preferred stocks, as shown by the average of the high and low quotations on the New York Stock Exchange (the principal market in which such stocks were traded), and Northwest common stock, and the rights issued by Pacific to purchase Northwest common stock as shown by the average of the high and low quotations on the American Stock Exchange (the principal market in which such stock and rights were traded) were as follows:

Date	Pacific Common	Pacific Preferred	Northwest Common	Rights
1961				
Jan. 27	35.1250	149.0625		
June 30	37.6875	155.0000		
Aug. 25	43.5000	169.0000		
Sept. 14	42.2500	164.9375	29.8125	2.234375
Sept. 29	38.6250	142.5000	26.8125	1.765625
Oct. 5	39.4375	146.0000	26.0000	1.65625
Oct. 20	38.0000	150.5000	27.8125	1.953125

As a result of the offering, the minority common and preferred shareholders of Pacific or their assignees acquired by exercising rights 1,897,891 shares of common stock of Northwest, and American (after purchasing two additional rights privately) on September 29, 1961, acquired all of the 15,548,140 shares of such stock for which it had received rights. The 17,446,031 shares of Northwest thus acquired by the shareholders of Pacific or their assignees by exercising rights had an aggregate fair market value of $468,852,920 at the various dates of exercise of the rights. Pacific received by reason of such acquisitions, cash in the amount of $279,136,496, of which amount $248,770,240 was received from American by its check dated September 29, 1961.

In the consolidated income tax return filed by American and its affiliated companies for 1961, gain was reported by Pacific on the sale of the 1,897,891 shares of Northwest common stock by Pacific to its minority common and preferred shareholders in the amount of $8,739,362.07. Since both American and Pacific were included in a consolidated return for 1961 no gain was reported on the sale of 15,548,140 shares of Northwest common stock by Pacific to American.

The offering price of $16 per share to Pacific shareholders of the portion of the common stock of Northwest offered to them in 1961 was determined by Pacific at a meeting of its board of directors on August 25, 1961. At such meeting Einerman, at the request of the President of Pacific, outlined to the board of directors the reasons therefor.

In addressing the board Einerman stated that there were two basic decisions to make in connection with the first offering of Northwest shares: (1) the price to be set for each share; and (2) if the price set was in excess of par value whether a change should be made in Pacific's dividend to compensate the shareholders for the additional capital invested in Pacific. He then discussed the time schedule that had been established for the offering, all of the dates of which fell in 1961. The necessary registration statement was to be filed with the Securities and Exchange Commission on August 25, its effective date was scheduled for September 13. When-issued trading in the Northwest stock and rights would commence on September 14, and the stock would go ex-rights on September 15. The appropriate stockholders of record of Pacific on September 20 would receive such rights which would be mailed to them in the form of stock warrants together with a prospectus on September 29. Such warrants would expire if not exercised by October 20.

Seven factors were presented for consideration in setting the offering price for the Northwest stock to be sold through rights in 1961. There were questions raised during this presentation with regard to these seven factors but none of the questions raised nor any of the discussion

that followed uncovered any additional factors over and above the seven, and equal importance was given to each. Those factors listed on a chart which was used to present them to the board as "factors to be considered" were as follows:

1. Tax status of rights to be issued.
2. Market value of shares to be sold.
3. Rights values received in the past.
4. Rights values at various offering prices.
5. Company's requirements for new capital.
6. Proceeds at various offering prices and shareholder's investment above par.
7. Taxes to be paid at various offering prices.

Some of these factors argued for a high offering price whereas the others tended to support a low offering price.

In behalf of Pacific's management Einerman recommended to the board, after giving appropriate weight to all seven factors, that the offering price for the Northwest shares to be sold through rights be set at $16 plus six rights. All of management's recommendations as made to the board by Einerman on August 25, 1961, were approved, and the rights were issued as set forth hereinbefore.

In order to insure the success of a distribution of stock through an issue of rights, the difference between the fair market value of the stock and the option price, referred to as the underpricing, must be sufficiently large in two respects. First, the underpricing in terms of dollar amount must be large enough to make it worthwhile for share-

holders to sell their rights if they do not choose to exercise them. Normally a cash value of $.20 for each right would be adequate. Secondly, the percentage of underpricing must be large enough to make the purchase of the stock a good investment, and insure that the rights will be exercised. Taking into account that the issuance of Northwest stock by Pacific was not underwritten, the maximum underpricing necessary to insure the success of the issue would have been 10 percent.

On April 22, 1963, pursuant to the Plan, Pacific's board of directors resolved to offer the remaining 13,013,969 shares of common stock of Northwest held by it to the shareholders of Pacific of record on June 4, 1963. On June 12, 1963, Pacific issued to its shareholders rights evidenced by assignable warrants to purchase all such shares at a price of $16 per share, exercisable at any time before the close of business on July 3, 1963. Rights were received by the minority common shareholders, minority preferred shareholders, and American, the common parent corporation of Pacific on the same basis as the 1961 offering of Northwest shares, except that American relinquished rights to purchase 8,829 shares of Northwest which it would otherwise have received under the Plan with respect to its common shares of Pacific, so that the minority common and minority preferred shareholders of Pacific could be offered shares of Northwest on a one-for-eight basis. The exercise of eight rights was required for the purchase of each share of Northwest.

As a result of the 1963 offering, the minority common and preferred shareholders of Pacific or their assignees acquired by exercise of their rights 1,416,552 shares of

Northwest, and American acquired the balance at $16 per share, including the 11,580,456 shares for which it had received rights which it exercised, and 16,961 shares also acquired by American, as provided in the Plan, constituting the shares offered to the minority common and preferred shareholders of Pacific for which shares the rights were allowed to lapse by such shareholders, or a total for American of 11,597,417 shares. In the two offerings, in 1961 and 1963, American thus acquired a total of 27,145,557 shares of Northwest, or about 89.1 percent of its single class of common stock.

The offering price of $16 per share to Pacific shareholders for the portion of the common stock of Northwest held by Pacific in 1963 and offered to the shareholders through rights in 1963 was determined by Pacific at a meeting of its board of directors on May 24, 1963. That determination was based upon the same factors which were presented to the board in regard to the setting of the offering price on the 1961 offering of Northwest stock by Pacific.

In response to requests by Pacific, the Commissioner issued a ruling letter on June 28, 1961 regarding the tax consequences of the planned division of Pacific and distribution of Northwest stock to the shareholders of Pacific through an issue of rights. In regard to the issuance of the rights and the distribution of the Northwest stock the Commissioner ruled as follows:

(6) The receipt by the shareholders of the Pacific Company of rights to purchase shares of stock of the Northwest Company will not result in taxable income to the shareholders.

(7) No taxable income will result to the shareholders of the Pacific Company by reason of holding the above-described rights to purchase shares of stock of the Northwest Company until the date of expiration of the rights, without having exercised, sold or exchanged them.

(8) The full amount realized by the shareholders of the Pacific Company upon the sale or exchange of the above-described rights to purchase shares of stock of the Northwest Company will constitute ordinary income to the shareholder so selling or exchanging the rights.

(9) The receipt by the shareholders of the Pacific Company of stock of the Northwest Company upon the exercise of the above-described rights, in case of each shareholder which is not a corporation, will result in a distribution of property under section 301 of the Code in an amount equal to the excess, if any, of the fair market value of the stock of the Northwest Company at the time of the exercise of the rights over the amount paid for the stock; and, in the case of each shareholder which is a corporation, will result in a distribution of property under section 301 in an amount equal to the excess, if any, of the basis of the stock of the Northwest Company in the hands of the Pacific Company at the time of the exercise of the rights over the amount paid for the stock, assuming the basis of such stock is less than its fair market value.

On November 15, 1962, the Commissioner issued another ruling letter to Pacific which reaffirmed the positions taken in the ruling of June 28, 1961, as set forth above.

OPINION

RAUM, *Judge:* American Telephone and Telegraph Company ("American"), a New York corporation, owned all of the stock or at least a controlling interest in the stock of some 21 corporations engaged in the business of furnishing telephone and other communications services within the United States. In the aggregate, American and its various subsidiaries comprise what is sometimes referred to as the Bell System. Its stock ownership in its west coast s bsidiary, Pacific Telephone and Telegraph Company ("Pacific"), represented some 89 percent of the latter's voting control. The minority shares in Pacific were publicly held by over 38,000 stockholders, including petitioners.

Pacific operated within the States of California, Oregon, Washington and a part of Idaho. Between the end of World War II and the beginning of 1961, Pacific's telephone business experienced enormous growth and was expected to continue to expand at a rapid rate. Due to this growth and the size of the area served by Pacific, many of its activities were controlled locally within the various states in which it operated. Eventually a separate division was set up to operate almost autonomously in the States of Oregon, Washington and Idaho. It was then concluded that it would be preferable to disassociate completely the activities of that division from the operations of Pacific in California by a transfer of the entire business conducted in the three northern states to a new corporation to be followed by a distribution to the shareholders of Pacific of the stock of the new corporation. To accomplish this objective Pacific Northwest Bell Tele-

phone Company ("Northwest") was organized as a Washington corporation on March 27, 1961, and as of July 1, 1961, Pacific transferred to it all of the assets pertaining to operations in the area to be served by the new corporation. In return for the assets received, Northwest assumed some of the liabilities to which such assets were subject, issued to Pacific a promissory note payable on demand in the principal amount of $200,000,000, and issued to Pacific 30,450,000 shares of its $11 par value common stock having an aggregate par value of $334,950,000.[3]

Since Pacific was then in need of additional capital to finance its own operations in California, the Plan to distribute the Northwest shares to Pacific's stockholders was devised in such manner that it would provide Pacific with such needed capital at the same time. This was accomplished by Pacific's issuing transferable short-term rights to its shareholders to buy the Northwest stock.[4] In order to receive a share of Northwest it was necessary to surrender six rights and to pay $16 in cash. Such Northwest stock was expected to have and did in fact have a fair market value substantially in excess of the $16 subscrip-

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[3]Pacific had previously purchased for $110,000 in cash 10,000 shares of Northwest common stock at par, which the Government agrees was an integral part of the later transfer.

[4]Pacific thus disposed of some 57.3 percent of its Northwest stock in 1961 and the remainder in 1963. There is no dispute between the parties that the two offerings were component parts of a single plan and that they must be regarded together as resulting in the disposition of 100 percent of the Northwest stock in a single transaction.

The amount of stock (57.3 percent) covered by the first offering was determined in such manner that direct control of the new corporation (over 50 percent stock ownership) would pass immediately from Pacific to American.

tion price. The petitioners in both cases before us exercised their rights thus obtaining shares of Northwest having a fair market value considerably greater than the cash paid therefor; also petitioners Gordon had four remaining rights which they sold for $6.36. Two principal problems are thus presented for solution: (1) Whether petitioners in both cases realized dividend income to the extent that the Northwest stock had a fair market value in excess of the subscription price; and (2) what is the proper tax treatment of the cash received by the Gordons upon the sale of their remaining rights?

1. *Exercise of rights.* There is no serious question that, apart from certain specific provisions of the 1954 Code, the exercise of rights by Pacific's stockholders in the circumstances of this case would result in their receiving taxable dividends equal to the excess of the value of the Northwest stock over the subscription price. So much is clear from such decisions as *Palmer v. Commissioner*, 302 U.S. 63, and *Choate v. Commissioner*, 129 F. 2d 684 (C.A. 2).[5] However, petitioners contend that there

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[5]The *Palmer* case has generally been regarded as based upon the theory that there may be a taxable dividend where the optioned stock is worth more than the subscription price at the time of the offering, and since the Northwest stock had a value substantially in excess of the subscription price at the time of issuance of the rights, there is not present here the condition for nontaxability that existed in the *Palmer* case itself. The scope of *Palmer* was considered at length in *Choate*, and, since the value of the Northwest stock on the dates of exercise of the rights herein was not in excess of its value on the date of issuance of the rights the problem which proved so troublesome in *Choate* is not before us. The Commissioner has charged petitioners with having received dividends only to the extent that the Northwest stock had a value on the date of exercise of the rights in excess of the subscription price, and such excess in turn was less than the corresponding excess as of the time of the offering.

are provisions in the 1954 Code which preclude the treatment of the foregoing amounts as taxable dividends. They argue that the transaction was completely tax-free under Section 355, dealing with the distribution of stock and securities of a controlled corporation (so-called spin-off or divisive reorganization), or alternatively under Section 354, involving exchanges of stock and securities in certain reorganizations. As a further alternative, they take the position that if Sections 355 and 354 are inapplicable, then the distribution resulting from the receipt of Northwest stock by petitioners was a distribution in partial liquidation of Pacific under Section 346(b), resulting in the realization of capital gains as provided therein. Since we have reached the conclusion that Section 355 is applicable, we do not pass upon the alternative contentions.

Section 355 is captioned "DISTRIBUTION OF STOCK AND SECURITIES OF A CONTROLLED CORPORATION." Subject to various conditions and limitations spelled out therein,[6] it was intended to provide for nonrecognition of gain or loss in a so-called spin-off or divisive reorganization, whereby a corporation divests

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[6]SEC. 355. DISTRIBUTION OF STOCK AND SECURITIES OF A CONTROLLED CORPORATION.

(a) Effect on Distributees.—

(1) General Rule.—If—

(A) a corporation (referred to in this section as the "distributing corporation")—

(i) distributes to a shareholder, with respect to its stock, or

(ii) distributes to a security holder, in exchange for its securities,

solely stock or securities of a corporation (referred to in this section as "controlled corporation") which it controls immediately before the distribution,

(B) the transaction was not used principally as a device for the distribution of the earnings and profits

itself of one of its business enterprises through the medium of distributing to its stockholders the stock of a subsidiary in which such business is being carried on at the time of distribution. See Sen. Rep. No. 1622, 83rd Cong., 2d Sess., pp. 266-268. It is undisputed that the telephone

of the distributing corporation or the controlled corporation or both (but the mere fact that subsequent to the distribution stock or securities in one or more of such corporations are sold or exchanged by all or some of the distributees (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device),

(C) the requirements of subsection (b) (relating to active businesses) are satisfied, and

(D) as part of the distribution, the distributing corporation distributes—

(i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or

(ii) an amount of stock in the controlled corporation constituting control within the meaning of section 368(c), and it is established to the satisfaction of the Secretary or his delegate that the retention by the distributing corporation of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax,

then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder or security holder on the receipt of such stock or securities.

* * * * * * *

(3) Limitation.—Paragraph (1) shall not apply if—

(A) the principal amount of the securities in the controlled corporation which are received exceeds the principal amount of the securities which are surrendered in connection with such distribution, or

(B) securities in the controlled corporation are received and no securities are surrendered in connection with such distribution.

For purposes of this section (other than paragraph (1)(D) of this subsection) and so much of section 356 as relates to this section, stock of a controlled corporation acquired by the distributing corporation by reason of any transaction which occurs within 5 years of the distribution of such stock and in which gain or loss was recognized in whole

and communications operations conducted in Oregon, Washington and Idaho constituted a separate business; and it is also undisputed that if Pacific had transferred that business to Northwest solely for stock of the latter

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or in part, shall not be treated as stock of such controlled corporation, but as other property.

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(b) Requirements as to Active Business.—

(1) In General.—Subsection (a) shall apply only if either—

(A) the distributing corporation, and the controlled corporation (or, if stock of more than one controlled corporation is distributed, each of such corporations), is engaged immediately after the distribution in the active conduct of a trade or business, or

(B) immediately before the distribution, the distributing corporation had no assets other than stock or securities in the controlled corporations and each of the controlled corporations is engaged immediately after the distribution in the active conduct of a trade or business.

(2) Definition.—For purposes of paragraph (1), a corporation shall be treated as engaged in the active conduct of a trade or business if and only if—

(A) it is engaged in the active conduct of a trade or business, or substantially all of its assets consist of stock and securities of a corporation controlled by it (immediately after the distribution) which is so engaged,

(B) such trade or business has been actively conducted throughout the 5-year period ending on the date of the distribution,

(C) such trade or business was not acquired within the period described in subparagraph (B) in a transaction in which gain or loss was recognized in whole or in part, and

(D) control of a corporation which (at the time of acquisition of control) was conducting such trade or business—

(i) was not acquired directly (or through one or more corporations) by another corporation within the period described in subparagraph (B), or

(ii) was so acquired by another corporation within such period, but such control was so acquired only by reason of transactions in which gain or loss was not recognized in whole or in part, or only by reason of such transactions combined with acquisitions before the beginning of such period.

(here Pacific received a $200,000,000 note in addition to stock), and if Pacific had then distributed the Northwest stock without consideration to its own stockholders (rather than through the medium of stock rights), the distribution would have qualified as a nonrecognizable spin-off. Such distribution would have been what petitioners properly characterize as a classic case of a tax-free divisive reorganization. And we hold that neither the use of stock rights nor the presence of the note requires a different result under Section 355.

Subject to the conditions spelled out in the four subparagraphs (A) through (D), Section 355(a)(1) provides in substance that where a corporation (the "distributing corporation") distributes to its shareholders stock of a corporation controlled by it no gain or loss shall be recognized by the distributees. Cf. *W. E. Gabriel Fabrication Co.,* 42 T.C. 545, 551. The principal controversy herein relates to subparagraphs (A) and (C). Subparagraph (B) is not involved at all since there is no contention that the transaction was used as a "device for the distribution of the earnings and profits" of either Pacific or Northwest. And subparagraph (D) is involved herein only in a manner closely related to subparagraph (A).

The conditions of subparagraph (A) appear in Section 355(a)(1) as follows:

SEC. 355. DISTRIBUTION OF STOCK AND SECURITIES OF A CONTROLLED CORPORATION.

(a) Effect on Distributees.—

(1) General Rule.—If—

(A) a corporation (referred to in this section as the "distributing corporation")—

(i) distributes to a shareholder, with respect to its stock, * * *

* * * * * * * *

solely stock or securities of a corporation (referred to in this section as "controlled corporation") which it controls immediately before the distribution,

* * * * * * * *

then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder or security holder on the receipt of such stock or securities.

As we understand the Government's position, it is that the conditions of (A) have not been satisfied since Pacific did not distribute the stock of Northwest but rather distributed rights to purchase the Northwest shares,[7] and that the stock of Northwest was in any event not distributed "with respect to its [Pacific's] stock". We think that these contentions are unsound.

The Government's position is based upon a highly technical and inhospitable reading of the statute that fails to give effect to the basic objective that Congress sought to achieve. This case concededly involves a spin-off. Pacific plainly divested itself of the business which it had conducted in the three northwest states. Had it distributed the Northwest stock directly to its stockholders without

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[7]It argues further at this point that such rights did not constitute "stock or securities" within Section 355 (a)(1)(A). In view of our conclusion that the shares of Northwest rather than the rights were the subject of the distribution within the meaning of (a)(1)(A) it becomes unnecessary to resolve the controversy as to whether the rights themselves would qualify as "stock or securities".

consideration there would clearly have been the type of divisive reorganization contemplated by the statute, at least as far as subparagraph (A) is concerned. And, in our view, the situation is not changed merely because that distribution was conditioned upon payment of $16 a share by the distributees. It was nonetheless a distribution of Northwest stock to these petitioners, stockholders in Pacific, made "with respect to" their ownership of stock in Pacific. If Congress had intended that a distribution of the Northwest stock be treated as tax-free when made without consideration, it is inconceivable that it could have intended the transaction to result in taxable income to the distributees where they *paid out* money in connection with receiving such stock. The stock of Northwest was literally "distributed" to petitioners, albeit for a consideration, and we hold that the statute should not be construed so as to depart from such literal meaning, where to do so would frustrate the legislative purpose.

The Government's argument revolves largely around the notion that the rights to subscribe were the subject of the distribution rather than the Northwest stock itself, and that the stock was obtained only as a result of exercising those rights. However, *Palmer v. Commissioner*, 302 U.S. 63,[8] makes it clear that issuance of the rights,

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[8]There is no merit to the Government's contention that *Palmer* is no longer good law in this respect. There is no indication in the 1954 Code that Congress intended to disapprove any part of that decision, and it has been applied by the courts in cases arising thereunder. See *William H. Bateman*, 40 T.C. 408. The employee stock option cases, *Commissioner v. LoBue*, 351 U.S. 243, and *Commissioner v. Smith*, 324 U.S. 177, relied on by the Commissioner as authority overruling *Palmer*, do not discuss this aspect of that case at all, but rather cite *Palmer* with approval in other respects.

even though they may be valuable, may not be considered as a distribution of corporate earnings and profits. If any income is to be charged to petitioners it must be regarded as stemming from the exercise of the rights, by obtaining the Northwest stock for a consideration less than its fair market value. But Section 355 was intended to permit the receipt of such stock without tax even where the recipient paid nothing therefor, and we think it would be a distortion of Congressional purpose to impute an intention to impose the tax where the recipient was required in effect to contribute to the capital of the distributing corporation as a condition to receiving the distributed stock. We conclude that the transaction before us was within the terms of Section 355(a)(1)(A), and we next consider whether the conditions of (a)(1)(C) have been met.

Subparagraph (C) is not self-contained, but incorporates other provisions by reference; it spells out as one of the conditions for nonrecognition in Section 355(a)(1) that:

> (C) the requirements of subsection (b) (relating to active businesses) are satisfied

Thus, subparagraph (C) is really nothing more than the means whereby the provisions of subsection (b) are brought into play at this point.

Subsection (b) provides in part as follows:

(b) Requirements as to Active Business.—

(1) In General.—Subsection (a) shall apply only if either—

(A) the distributing corporation, and the controlled corporation * * * is engaged immediately after the distribution in the active conduct of a trade or business, or

* * * * * * *

(2) Definition.—For purposes of paragraph (1), a corporation shall be treated as engaged in the active conduct of a trade or business if and only if—

(A) It is engaged in the active conduct of a trade or business, or substantially all of its assets consist of stock and securities of a corporation controlled by it (immediately after the distribution) which is so engaged,

(B) such trade or business has been actively conducted throughout the 5-year period ending on the date of the distribution,

(C) such trade or business was not acquired within the period described in sub-paragraph (B) in a transaction in which gain or loss was recognized in whole or in part, and

* * * * * * *

There is no dispute that Pacific and Northwest were each engaged in the active conduct of a trade or business within (b) (1) (A), or that the requirements of (b) (2) (A) and (b) (2) (B) have been met. However, the Government argues that there has been a failure in respect of Northwest to comply with (b) (2) (C), in that the transaction whereby Northwest acquired its business from Pacific was one "in which gain or loss was recognized in whole or in part." Petitioners vigorously deny that any gain or loss was recognized.

The purpose of these provisions was to prevent a tax-free distribution of a corporation's earnings and profits through the medium of a temporary purchase of a going business with liquid assets and then in effect distributing those assets to its stockholders. See Cohen, Silverman, Surrey, Tarleau and Warren, *The Internal Revenue Code of 1954: Corporate Distributions, Organizations, and Reorganizations,* 68 Harv. L. Rev. 393, 430. Plainly, no such circumstances were present here, since this case involves a bona fide separation of a business conducted for many years by Pacific. We turn then to the particular contentions urged by petitioners in support of their position that the gain on the transfer of assets by Pacific to Northwest was nonrecognizable. They rely upon two alternative grounds: (1) that as a result of the consolidated return filed in behalf of Pacific and the affiliated group, no gain or loss was in fact recognized; and (2) that in any event the transfer of the business by Pacific to Northwest was nonrecognizable under Section 351.[9]

It is in connection with this second ground that the matter of the $200,000,000 note becomes pertinent, since the Government contends that Pacific's transfer to Northwest was not "solely in exchange for stock or securities" of Northwest, in view of the note as part of the

[9] SEC. 351. TRANSFER TO CORPORATION CONTROLLED BY TRANSFEROR.

(a) General Rule.—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation. * * *

consideration for the transfer. Petitioners, on the other hand, argue that the note is a security within the meaning of Section 351. We need not resolve this controversy, because, in our view, there was no recognizable gain or loss by reason of the consolidated return, and it therefore becomes unnecessary to consider the alternative ground.

As subsidiaries of American, Pacific and Northwest were included in the group of affiliated corporations for which a consolidated return was filed for 1961. Thus, the gain resulting from the transfer of assets from Pacific to Northwest which might otherwise have been subject to tax was eliminated in that consolidated return pursuant to regulations prescribed by the Commissioner under Section 1502. Those regulations provide as follows (Regulations 1.1502-31 (b) (1)):

> (b) *Computations.* In the case of affiliated corporations which make, or are required to make, a consolidated return, and except as otherwise provided in the regulations under section 1502:
>
> (1) *Taxable income.* The taxable income of each corporation shall be computed in accordance with the provisions covering the determination of taxable income of separate corporations, except:
>
> (i) There shall be eliminated unrealized profits and losses in transactions between members of the affiliated group and dividend distributions from one member of the group to another member of the group (referred to in the regulations under section 1502 as intercompany transactions);

The Government does not dispute that the gain upon the transfer from Pacific to Northwest was properly relieved

of tax in the consolidated return. It argues, however, that the regulations provide for the *elimination* of gain or loss whereas Sections 355 (b) (2) (C) and 351 are phrased in terms of *nonrecognition* of gain or loss. It contends that the gain herein was "recognized" but "eliminated." We think that this distinction is spurious, and that the terms "elimination" and "nonrecognition" are intended to be synonymous in this context. Apart from the absence of any solid basis for the claimed distinction, a careful textual examination of the statute and regulations discloses that the word "eliminated" was used in the sense of "nonrecognition."

Under the regulations "unrealized profits and losses" arising out of intercompany transactions are to be "eliminated." Here, it is undisputed that the gain on the transfer from Pacific to Northwest was properly "eliminated," and therefore must have been an "unrealized" gain within the meaning of these provisions. Yet Section 1002 directs that, except as otherwise provided, the entire gain or loss on a sale or exchange of property determined under Section 1001 shall be "recognized." And Section 1001 (a) states that the gain on sale of property "shall be the excess of the amount realized therefrom over the adjusted basis***." Thus, if no gain were "realized" within the meaning of the regulations so as to justify "elimination," no such gain was "recognized."

This result is confirmed by examining the consequences that would follow in respect of the basis of the transferred property. Section 1051, dealing with the basis of property acquired in an intercompany transaction, provides as follows:

SEC. 1051. PROPERTY ACQUIRED DURING AFFILIATION

> In the case of property acquired by a corporation, during a period of affiliation, from a corporation with which it was affiliated, the basis of such property, after such period of affiliation, shall be determined, in accordance with regulations prescribed by the Secretary or his delegate, without regard to intercompany transactions in respect of which gain or loss was not recognized.***

The basis of the property is thus to be determined "without regard to inter-company transactions in respect of which gain or loss was not recognized." However, if gain were "recognized" in such a transaction, the basis of the property in the hands of the transferee would be "increased in the amount of gain recognized to the transferor." Section 362.

Plainly, all of the foregoing provisions contemplate *nonrecognition* of gain or loss in intercompany transactions, with the result that the transferred property retains its basis in the hands of the transferee. If "elimination" meant something different from "nonrecognition," and if the Commissioner were correct here, then we would have the bizarre situation where the gain were "recognized" even though "eliminated" and the property transferred would acquire a stepped-up basis even though no tax were paid on the gain. We can hardly imagine the Commissioner accepting any such result without a struggle. The real difficulty is due to his unsound position here. We hold that the gain "eliminated" in the consolidated return was not "recognized," with the con-

sequence that the requirements of Section 355 (b) (2) (C) have been met, thus complying with the condition of Section 355 (a) (1) (C).

There remains finally for consideration whether the condition of Section 355 (a) (1) (D) has been met. As already noted subparagraph (D) is closely related to (A) as it is involved herein. It requires that—

> (D) as part of the distribution, the distributing corporation distributes—
>
> (i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or
>
> (ii) an amount of stock in the controlled corporation constituting control within the meaning of section 368(c), * * *

Certainly, Pacific disposed of every share of Northwest, retaining none whatever, thus satisfying the underlying objective of subparagraph (D).[10] The reasoning behind the Government's highly technical argument that Pacific did not "distribute" all the Northwest stock is basically the same as its position under (A), and rests on the notion that the issuance of the stock rights and the exercise thereof preclude a finding that Pacific had

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[10] That objective has been satisfied by Pacific's parting with every share of Northwest. However, if it be thought necessary that such distribution be made to the stockholders of Pacific, the fact that some shares were transferred to purchasers of rights rather than to the stockholders is immaterial here. For, not only did the ultimate transferees take through the stockholders, but in any event the record discloses that the stock rights sold represented only a small percentage of the rights issued, and at least more than 80 percent of the shares, constituting control under Section 368(c), were in fact distributed to shareholders of Pacific, thus satisfying either part (i) or (ii) of subparagraph (D).

"distributed" all of the Northwest stock. We reject that position here in accordance with the conclusion that we reached in respect of the argument relating to (A).

2. *Sale of rights.* The remaining issue concerns the taxation of the proceeds received by petitioners Gordon from the sale of four of the rights issued to them. This sale took place on October 5, 1961, and the Gordons received \$6.36 for the four rights or \$1.59 each. In *Gibson v. Commissioner,* 133 F. 2d 308 (C.A. 2), the court held that a sale of rights results in "ordinary income" at least "to the extent of the spread between the market value of the stock at the time of the issuance of the option and the option price for the stock" (p. 309).

The value of the rights herein on the issuance date, September 29, 1961, was greater than \$1.59 per right so that there is not presented here any problem comparable to that considered in *Choate v. Commissioner,* 129 F. 2d 684 (C.A. 2), where the market value of the optioned stock increased after the rights were issued.

In *Gibson,* the court determined that the petitioner there received an option to obtain a distribution, and through a sale of her rights she anticipated that distribution. The amount realized in anticipation of the distribution was required to be treated in the same manner as the distribution itself. Cf. *Helvering v. Horst,* 311 U.S. 112.

Petitioners accept this reasoning, but contend that since under Section 355 the distribution of stock in the present case is nontaxable and no gain would be recognized until a sale of the stock, the amounts realized from a sale of the rights should be taxed in the same manner as gains

from sales of the stock, i.e., capital gains. This argument fails to take into account the nature of Section 355, which is a nonrecognition provision, and can be utilized only by those shareholders who come within its terms. Those shareholders who sold their rights did not come under Section 355 in respect of such rights,[11] and without Section 355 a distribution of the stock of another corporation would have resulted in the distribution of a dividend to the shareholders of the distributing corporation. The anticipation of such a distribution results in a realization of income which must similarly be treated as a dividend to which the dividends received credit applies. Cf. *Tobacco Products Export Corporation*, 21 T.C. 625.

Decision, will be entered for the petitioners in Docket No. 949-63.

Decision will be entered under Rule 50 in Docket No. 3949-63.

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[11]The same would be true with respect to any other provisions, such as those in Section 354, upon which petitioners might rely as a ground for relieving them of the tax upon the exercise of the rights, even if we were to hold such provisions applicable in such circumstances, an issue that we found unnecessary to decide. See p. 35, *supra*.

Appendix C

United States Court of Appeals
For the Ninth Circuit

Commissioner of Internal Revenue, Petitioner, vs. Oscar E. Baan and Evelyn K. Baan, Respondents.	No. 20,863

[July 7, 1967]

On Petition for Review of the Decision of the Tax Court of the United States

Before: HAMLEY, MERRILL and ELY, Circuit Judges

HAMLEY, Circuit Judge:

The Commissioner of Internal Revenue (Commissioner) determined a deficiency in the 1961 income tax of Oscar E. and Evelyn K. Baan, in the amount of $284.44. Taxpayers petitioned the Tax Court for a redetermination of the Commissioner's finding. The Tax Court decided there was no deficiency, its opinion being reported at 45 T.C. 71. The Commissioner petitioned this court to review that decision.

During 1961, taxpayers owned six hundred shares of Pacific Telephone and Telegraph Company (Pacific) common stock. In that year they received six hundred stock rights, represented by transferable stock purchase war-

rants issued by Pacific, entitling them to purchase one share of Pacific Northwest Bell Telephone Company (Northwest) common stock for sixteen dollars and six stock rights.

On October 11, 1961, taxpayers exercised their stock rights and, in consideration for $1,600 ($16 per share) and the surrender of the six hundred stock rights, received one hundred shares of Northwest stock. The fair market value of Northwest common stock on October 11, 1961, was $26.94 per share.

In their joint federal income tax return for that year, taxpayers did not include as income any amount with respect to the issuance of the six hundred rights to purchase Northwest stock, or any amount with respect to the purchase by them of one hundred shares of Northwest stock upon the surrender of the six hundred rights and the payment of $1,600. The Commissioner determined that the difference between the fair market value of the Northwest stock received and the sixteen dollars per share paid constituted a taxable dividend.

In the redetermination proceedings the Tax Court rejected the Commissioner's contention. The issue has been renewed in this review proceeding. The essential facts are not in dispute and the following statement of those facts is taken, almost verbatim, from the Commissioner's opening brief.[1]

Prior to July 1, 1961, Pacific, a California corporation, furnished communication services in California, Oregon, Washington and part of Idaho. Beginning in 1960, the

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[1] A more complete statement is set out in the Tax Court's reported statement of facts and opinion, at 45 T.C. 71.

California and non-California businesses of Pacific were operated by separate divisions. For a number of business reasons, the management and shareholders of Pacific decided early in 1961 that the non-California business should be handled by a separate corporation. Accordingly, on March 27, 1961, Pacific caused the organization of Northwest, a Washington corporation. The following day ten thousand shares of Northwest common stock were issued to Pacific upon the payment by Pacific to Northwest of $110,000 in cash.

As of June 30, 1961, all of the business and properties of Pacific in Oregon, Washington and Idaho were transferred to Northwest in exchange for (1) the issuance to Pacific by Northwest of an additional 30,450,000 shares of its common stock, (2) the issuance to Pacific by Northwest of an interest-bearing demand note in the amount of $200,000,000, and (3) assumption by Northwest of certain liabilities of Pacific in Oregon, Washington and Idaho. At the close of business on June 30, 1961, Pacific ceased all operations in Oregon, Washington and Idaho, and Northwest commenced operations in these states on the next day.

An integral part of the plan for dividing the businesses of Pacific was the sale of Northwest stock to Pacific shareholders or their assigns. Assignable stock rights were to be issued to Pacific shareholders which would enable them either to purchase Northwest stock upon surrender of the rights plus the payment of cash in an amount to be set by Pacific's board of directors, or to sell the rights to others who could so exercise them. The purpose of the plan to require a cash payment in addi-

tion to the surrender of the stock rights was to provide Pacific with funds for its future operations in California.

On August 25, 1961, Pacific's board of directors decided that the offering price of Northwest stock to Pacific shareholders, or to those who had purchased the stock rights from shareholders, should be sixteen dollars per share. Pacific shareholders were to receive one transferable stock purchase warrant for each share of Pacific held, with six rights plus the payment of sixteen dollars required to obtain one share of Northwest stock. Between the time of the issuance of the rights (September 20, 1961) and the deadline for their exercise (October 20, 1961), the fair market value of Northwest stock was no less than twenty-six dollars per share.

The Northwest stock disposed of by Pacific in the above-described 1961 offering amounted to approximately fifty-seven percent of the total number of Northwest shares held by Pacific.[2] It had been planned by Pacific

[2] American Telephone and Telegraph Company (American), owned approximately ninety percent of Pacific's common stock. The bulk of the total of 17,446,031 shares of Northwest sold by Pacific in 1961, namely 15,548,140 shares, was thus acquired by American. The minority shareholders of Pacific, or their assignees, acquired the remaining 1,897,891 shares of Northwest. For the Northwest stock it sold in 1961, Pacific received cash in the total amount of $279,136,496.

On the consolidated income tax return filed by American and its subsidiaries for the year 1961 (which return included Pacific) no gain or loss was reported on the transaction in which Pacific transferred its non-California assets to Northwest. Similarly, since it was not required to report gains or losses in certain inter-company transactions, no gain was reported on the 1961 consolidated return on the sale of 15,548,140 shares of Northwest common by Pacific to American. Gain was reported by Pacific, however, in the amount of $8,739,362.07, with respect to the 1,897,891 shares of Northwest sold by Pacific to its minority shareholders or their assignees in 1961.

from the outset that the remainder would be held for disposition at a later time to be determined by Pacific's board of directors. The remaining forty-three percent of Northwest stock held by Pacific was offered to Pacific's shareholders on June 12, 1963, at the same price of sixteen dollars per share, the principal difference being that eight stock rights, instead of six, were required.[3]

As of December 31, 1960, Pacific had unappropriated earned surplus in the amount of \$192,053,880.76. As of December 31, 1961, Pacific had \$178,935,190.15 of unappropriated earned surplus. There was a sufficient dollar amount of earnings and profits of Pacific in 1961 from which a 1961 dividend could have been paid by Pacific to its shareholders to cover the dollar amounts which the Commissioner contended in this case were received by taxpayers and other shareholders as dividend income.[4]

On these facts, the Tax Court decided that the transaction whereby Pacific sold its non-California business to

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[3]As a result of the June 12, 1963 offering of the remainder of Northwest stock, American acquired an additional 11,597,417 shares of Northwest, and the minority shareholders of Pacific acquired the remaining 1,416,552 shares of Northwest.

[4]In response to requests by Pacific, the Commissioner issued a ruling letter on June 28, 1961, regarding the tax consequences of the planned division of Pacific and the distribution of Northwest stock through an issue of assignable rights and the payment of cash. Essentially, the Commissioner ruled that, in the case of Pacific's shareholders who sold their rights, the full amount realized would be ordinary income to them and that, in the case of individual Pacific shareholders who exercised their rights, the difference between the fair market value of Northwest stock (on the date the rights were exercised) and the sixteen dollars per share price paid would be taxed to such shareholders as dividend income. On November 15, 1962, the Commissioner issued another ruling letter to Pacific which reaffirmed the position taken in the ruling of June 28, 1961.

Northwest and then sold the Northwest stock to its own shareholders or their assignees, qualified as a tax-free spin-off within the terms and intendment of section 355 of the Internal Revenue Code of 1954, 26 U.S.C. § 355 (1964).[5] Consequently, the Tax Court ruled that the taxpayers were not taxable on the gain realized by them when they exercised their rights to acquire Northwest stock having a fair market value of $26.94 per share at a cost to them of sixteen dollars per share.

As the Tax Court stated in its opinion, there is no serious question that, apart from certain specific provisions of the 1954 Code, the exercise of rights by Pacific's stockholders in the circumstances of this case would result in classifying, as taxable dividends, the excess of the value of the Northwest stock over the subscription price. As indicated above, section 355 was primarily relied upon by taxpayers in seeking, and the Tax Court in granting, non-recognition of the gain realized by taxpayers as a result of their exercise of the rights in question.

The Commissioner argues, however, that four specific requirements of section 355 remain unsatisfied in this case and it was therefore error to grant, on the basis of that statutory provision, non-recognition to this otherwise taxable gain. Section 355 is quoted in the margin.[6]

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[5]Section references throughout this opinion will be to the Internal Revenue Code of 1954, unless otherwise expressly stated.

[6]Section 355 reads as follows:

"§355. *Distribution of stock and securities of a controlled corporation.*

"(a) *Effect on distributees.*

"(1) *General rule.*

"If—

"(A) a corporation (referred to in this section as the 'distributing corporation')—

Before discussing these asserted requirements of section 355, and the question of whether they were here satisfied,

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"(i) distributes to a shareholder, with respect to its stock, or

"(ii) distributes to a security holder, in exchange for its securities,

solely stock or securities of a corporation (referred to in this section as 'controlled corporation') which it controls immediately before the distribution,

"(B) the transaction was not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both (but the mere fact that subsequent to the distribution stock or securities in one or more of such corporations are sold or exchanged by all or some of the distributees (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device),

"(C) the requirements of subsection (b) (relating to active businesses) are satisfied, and

"(D) as part of the distribution, the distributing corporation distributes—

"(i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or

"(ii) an amount of stock in the controlled corporation constituting control within the meaning of section 368 (c), and it is established to the satisfaction of the Secretary or his delegate that the retention by the distributing corporaion of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax,

then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder or security holder on the receipt of such stock or securities.

"(2) *Non pro rata distributions, etc.*

"Paragraph (1) shall be applied without regard to the following:

"(A) whether or not the distribution is pro rata with respect to all of the shareholders of the distributing corporation,

"(B) whether or not the shareholder surrenders stock in the distributing corporation, and

"(C) whether or not the distribution is in pursuance of a plan of reorganization (within the meaning of section 368(a)(1)(D)).

it will be helpful to review briefly the legislative history of that section.

"(3) *Limitation.*

"Paragraph (1) shall not apply if—

"(A) the principal amount of the securities in the controlled corporation which are received exceeds the principal amount of the securities which are surrendered in connection with such distribution, or

"(B) securities in the controlled corporation are received and no securities are surrendered in connection with such distribution.

"For purposes of this section (other than paragraph (1)(D) of this subsection) and so much of section 356 as relates to this section, stock of a controlled corporation acquired by the distributing corporation by reason of any transaction which occurs within 5 years of the distribution of such stock and in which gain or loss was recognized in whole or in part, shall not be treated as stock of such controlled corporation, but as other property.

"(4) *Cross reference.*

"*For treatment of the distribution if any property is received which is not permitted to be received under this subsection (including an excess principal amount of securities received over securities surrendered), see section* 356.

"(b) *Requirements as to active business.*

"(1) *In general.*

"Subsection (a) shall apply only if either—

"(A) the distributing corporation, and the controlled corporation (or, if stock of more than one controlled corporation is distributed, each of such corporations), is engaged immediately after the distribution in the active conduct of a trade or business, or

"(B) immediately before the distribution, the distributing corporation had no assets other than stock or securities in the controlled corporations and each of the controlled corporations is engaged immediately after the distribution in the active conduct of a trade or business.

"(2) *Definition.*

"For purposes of paragraph (1), a corporation shall be treated as engaged in the active conduct of a trade or business if and only if—

"(A) it is engaged in the active conduct of a trade or business, or substantially all of its assets consist of stock and securities of a corporation controlled by it (immediately after the distribution) which is so engaged,

"(B) such trade or business has been actively conducted throughout the 5-year period ending on the date of such distribution,

A spin-off occurs where a part of the assets of a corporation is transferred to a new corporation and the stock of the transferee is distributed to the shareholders of the transferor without the surrender by them of stock in the transferor. See 3 MERTENS, LAW OF FEDERAL INCOME TAXATION (Zimet and Weiss Revision) § 20.100, page 491. Congress apparently first permitted the tax-free treatment of spin-off transactions in section 203(c) of the Revenue Act of 1924, ch. 234, 43 Stat. 256 (1924). Because of the general terms of that and subsequent enactments,[7] Congress soon recognized that wide-spread tax avoidance might result.[8]

"(C) such trade or business was not acquired within the period described in subparagraph (B) in a transaction in which gain or loss was recognized in whole or in part, and

"(D) control of a corporation which (at the time of acquisition of control) was conducting such trade or business—

"(i) was not acquired directly or through one or more corporations) by another corporation within the period described in subparagraph (B), or,

"(ii) was so acquired by another corporation within such period, but such control was so acquired only by reason of transactions in which gain or loss was not recognized in whole or in part, or only by reason of such transactions combined with acquisitions before the beginning of such period."

[7]Other similar enactments followed the 1924 statute: Revenue Act of 1926, ch. 27, § 203(c), 44 Stat. 13 (1926); Revenue Act of 1928, ch. 852, § 112(g), 45 Stat. 818 (1928); Revenue Act of 1932, ch. 209, § 112(g), 47 Stat. 197 (1932).

[8]At least arguably, the 1924 statute would have permitted the transfer of liquid assets to a new corporation. The new corporation's shareholders would then be in a position to liquidate the new corporation and so receive the liquid assets as a liquidating distribution taxable at capital gains rates. Such a transaction was actually litigated in *Gregory v. Helvering*, 293 U.S. 465. See 3 MERTENS, LAW OF FEDERAL INCOME TAXATION (Zimet and Weiss Revision) §§ 20.55, 20.101, pages 193-203, 496-498.

Congress reacted to this possibility by eliminating the provision which characterized the spin-off as a non-taxable reorganization. See the Revenue Act of 1934, ch. 277, 48 Stat. 680, 704 (1934). From then until 1951, without regard to whether a particular transaction served a legitimate business need, the gain realized by a shareholder as a result of a spin-off was subject to tax as an ordinary dividend.

In 1951, Congress reconsidered its position, having come to the view that business reasons could exist which would justify allowing tax-free status to the division of a single corporation into two or more corporations each owned directly by the shareholders. Therefore, in that year, Congress reinstated non-recognition treatment to those spin-offs which met carefully specified conditions. In so doing Congress additionally provided that ordinary dividend treatment would still be accorded the transaction, even if it would otherwise qualify under the new spin-off provisions, if the transaction was principally used as a "device" for distributing earnings and profits to the shareholders of any corporation that was a party to the reorganization. See section 112(b)(11) of the Internal Revenue Code of 1939, added by section 317 of the Revenue Act of 1951, ch. 521, 65 Stat. 493 (1951).

In the Internal Revenue Code of 1954, Congress sought to create a single set of limitations that would govern all forms of transactions having the potential of either a bona fide business transaction or a tax avoidance scheme. Under the 1954 Code, which is applicable in this case, such transactions, including not only spin-offs, but also so-called split-offs and split-ups, are to be tested under

the provisions of section 355.[9] In addition to further circumscribing the basic prerequisite for non-recognition, section 355 also carried over the "device" restriction that was part of the 1951 legislation. See 3 MERTENS, LAW OF FEDERAL INCOME TAXATION (Zimet and Weiss Revision) § 20.101, pages 494-503.

The Commissioner argues that, in the four following respects, each of which is indispensable, the transaction here in question failed to satisfy essential requirements of section 355:

(1) Pacific did not "distribute" solely stock or securities to taxpayers "with respect to its stock," as assertedly required by section 355(a)(1)(A).

(2) Since Pacific did not distribute "control" of Northwest without consideration, it did not meet the asserted requirements of section 355(a)(1)(D).

(3) Pacific did not distribute control of Northwest in a single distribution, as assertedly required by section 355(a)(1)(D).

(4) Contrary to the requirement of section 355(b)(2)(C), Northwest acquired its telephone business from Pacific in a transaction in which gain was "recognized."

We will first consider, together, the first two of these contentions. Both of them are generally directed to the

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[9] A split-off involves the same kind of transaction as a spin-off except that the shareholders surrender part of their stock in the parent corporation in exchange for stock in the subsidiary. In a split-up, the parent corporation transfers substantially all its assets to two or more corporations and then liquidates, its stockholders surrendering all their stock in the transferor and receiving the stock in the transferee corporations. See Note, *Tax Treatment of Corporate Divisions*, 52 COLUM. L. REV. 408, 409 (1952); Mintz, *Divisive Corporate Reorganizations: Split-Ups and Split-Offs*, 6 TAX L. REV., 365 (1951).

section 355(a)(1)(A) provision that non-recognition of gain will be granted only if the distributing corporation (Pacific) distributes to a shareholder (taxpayers), "with respect to its stock" (with respect to taxpayers' ownership of Pacific's stock), "solely stock or securities" of a controlled corporation (Northwest) which the distributing corporation controls immediately before the distribution.

Beyond question, Pacific distributed stock rights to taxpayers with respect to their ownership of Pacific stock. This is shown by the fact that taxpayers received one stock right for each share of Pacific which they owned, without being required to give any consideration to Pacific.

This is not the kind of distribution, however, which is exempted from taxation under section 355(a)(1)(A). That statutory provision relates "solely" to the distribution of "stock or securities" of the controlled corporation.[10] Further, in view of section 355(a)(1)(D)(ii), which incorporates the "control" definition of section 368(c), the "stock or securities" distributed must carry voting rights. Stock rights are not stocks or securities and, most assuredly, are not stocks or securities carrying voting rights. They are only options to purchase stock. See *Helvering v. Southwest Consolidated Corp.*, 315 U.S. 194, 200-201.

[10]The following statement appears in section 1.355-1(a) of the Treasury Regulations on Income Tax (1954 Code): "For the purpose of section 355, stock rights or stock warrants are not included in the term 'stock or securities.'" For a detailed discussion of the term "stock or securities," see 3 MERTENS, LAW OF FEDERAL INCOME TAXATION (Zimet and Weiss Revision) § 20.67, pages 285-286. But see Note, 35 U.CINC.L.REV. 254, 256 (1966).

It follows that section 355 does not here afford a basis for non-recognition of gain or loss unless the manner in which Northwest stock, as distinguished from the voting rights, was transferred from Pacific to taxpayers, constituted a "distribution" to them with respect to their ownership of Pacific's stock, within the meaning of that section.

For present purposes we may assume that intercession of a stock rights scheme would not, standing alone, prevent a transfer of Northwest stock from Pacific to taxpayers from constituting a distribution with respect to taxpayers' ownership of Pacific's stock. But this stock rights scheme did not stand alone. In addition to surrendering six stock rights, taxpayers were also required to pay sixteen dollars for each share of Northwest stock acquired. The transaction then became a sale of corporate assets.

Although the Supreme Court said in *Palmer v. Commissioner,* 302 U.S. 63, 69, that a sale of corporate assets to stockholders is, in a literal sense, a "distribution" of its property, we do not believe that it is the kind of distribution contemplated by section 355. Instead of being simply a distribution with reference to taxpayers' ownership of Pacific's stock, it is a distribution with reference to that ownership *plus* the payment of sixteen dollars a share.

As the Commissioner correctly states in his argument to this court, whatever meaning may be attached to the word "distribute," standing by itself or in a different context, the phrase "distributes . . . with respect to . . . stock" is a term of art with a consistent meaning

throughout the Code. It is used only to refer to distributions without consideration, not to sales for a cash consideration.[11]

Contrary to taxpayers' contention, there is no contradiction between a view which interprets only distributions without consideration as being within the section 355 phrase, "distributes . . . with respect to . . . stock," and the Commissioner's determination that taxpayers received a distribution from Pacific which is taxable as a dividend under section 301 of the Code, 26 U.S.C. § 301 (1964). It is true that both sections refer to a distribution made by a corporation to a shareholder ". . . with respect to its stock. . . ." However, section 355 relates this provision to the distribution of "solely stock or securities of a corporation . . .," whereas section 301 relates this provision to the distribution of "property (as defined in section 317(a))."

Section 317(a), 26 U.S.C. § 317 (1964), makes it clear that "property" is not limited to stock or securities but may include "any other property." Thus Pacific's distribution of stock rights "with respect to its stock" logically constitutes the distribution of property within the meaning of section 301, but, for the reasons stated above, does not constitute the distribution of "stock or securities" within the meaning of section 355.[12]

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[11]See section 301 (distributions of property), section 305 (distributions of stock and stock rights), section 307 (basis of stock and stock rights acquired in distributions), section 311 (taxability of corporations on distributions), and section 312 (effect of a distribution on corporate earnings and profits).

[12]Taxpayers point to sections 1.301-1(j) and (k) of the Treasury Regulations on Income Tax (1954 Code) as contradicting the

The dividend ruling by the Commissioner was with respect to the distribution of assignable stock rights to Pacific shareholders. It is true, as the Supreme Court said in *Palmer v. Commissioner,* 302 U.S. 63, 71, that the mere issue of rights to subscribe and their receipt by shareholders is not a dividend. But where, as in our case, this is coupled with the fact that, at the time of the distribution of stock rights, there is a "spread" between the fair market value of the stock and the purchase price as called for by the stock rights, an intention to declare a dividend is indicated. The amount of the dividend, determinable at the time the shareholder of the distributing corporation exercises his stock rights, is the lower of the "spread" on the date of issue or the "spread" on the date of exercise. See *Choate v. Commissioner,* 2 Cir., 129

Commissioner's contention that, throughout the 1954 Code, the phrase "distribution . . . to a shareholder with respect to its stock" never means distribution for a *cash* consideration.

Income Tax Regulation 1.301-1(j) does not pertain to distributions to a shareholder "with respect to its stock," but to the "transfer" of property by a corporation to a shareholder for an amount less than its fair market value in a sale or exchange. With respect to such transaction, this regulation provides that such shareholder shall be "treated" as having received a distribution to which section 301 applies. The plain meaning of this regulation is to bring within the provisions of section 301, certain transactions which are not strictly distributions of property by a corporation "with respect to its stock."

Income Tax Regulation 1.301-1(k) demonstrates how (j) is to be applied, by giving as an example, a purchase by a shareholder, from his corporation, for twenty dollars, property having a fair market value of one hundred dollars. The rule indicates that under these circumstances the amount of the distribution determined under section 301(b) is eighty dollars. This example demonstrates that Regulation 1.301-1(j) does not deal with distributions of corporate property "with respect to its stock," but to other kinds of corporate transfers to shareholders which will nevertheless be treated as if they were stock distributions.

F.2d 684, 687. *Cf. Commissioner v. LeBue,* 351 U.S. 243, 249.[13]

Taxpayers call attention to the fact that, in view of section 355(a)(2)(B), there may be a section 355(a)(1)(A)(i) distribution to a shareholder "with respect to its stock," even though the plan calls for the shareholder to surrender stock in the distributing corporation.[14] Likening such a surrender of stock by a shareholder to the payment of consideration for stock being distributed to a shareholder, taxpayers argue that a distribution of stock of a controlled corporation under a plan which calls for a cash payment by the distributing corporation's shareholders, is likewise a distribution "with respect to its stock."

If, as part of a plan to distribute to its shareholders the stock of a controlled corporation, the distributing corporation requires that recipient shareholders surrender stock in the *distributing* corporation, it is patently a distribution to the shareholder "with respect to its stock," just as much as if no surrender of such stock were required. No factor unassociated with the shareholder's ownership of the distributing corporation's stock has been introduced. But where the plan requires a cash payment by a recipient shareholder, a new element, unassociated

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[13]In our case, the value of the Northwest stock on the date of exercise of the rights by the taxpayers did not exceed the value of that stock on the date of issuance of the rights.

[14]The provision of section 355(a)(2)(B), to the effect that section 355(a)(1) shall be applied without regard to whether or not the shareholder surrenders stock in the distributing corporation, was designed to make section 355(a)(1) applicable to "split-offs" and "split-ups," as well as "spin-offs." MERTENS, LAW OF FEDERAL INCOME TAXATION, Code Commentary, § 355(a): 3, page 219.

with a shareholder's ownership of the distributing corporation's stock, has been interjected.

As we view it, the impact of the section 355(a)(2)(B) provision to which taxpayers call attention, as related to our problem, runs against, instead of in favor of, taxpayers' position. Congress made clear in this section that a surrender of stock in the distributing corporation would not defeat a section 355(a)(1) transaction, but it made no such exception in the case of plans calling for cash payments from recipient shareholders.[15]

Taxpayers argue that sections 354 and 356 of the Code, 26 U.S.C. §§ 354 and 356 (1964), support their view that section 355 does not preclude the payment of cash by a tax-free distributee. We do not agree. Neither section 354 nor section 356 pertains to a distribution by a corporation "with respect to its stock," which is an express limitation in a section 355(a)(1)(A)(i) transaction under which taxpayers have sought to proceed.

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[15]Taxpayers also direct our attention to the fact that the term "distributes" as used in (ii) of section 355(a)(1)(A) clearly refers to transfers by a corporation for a consideration, namely exchanges by a distributing corporation of stock or securities of the controlled corporation for its own "securities." Taxpayers argue that the surrender of "securities" under this provision is one form of consideration, thereby indicating that the term "distributes . . . with respect to . . . stock," as used in (i) of section 355(a)(1)(A) was intended to be used in its broadest sense, and could include distributions involving a payment of a cash consideration by recipient shareholders.

However, this argument lacks substance when it is noted that the words "with respect to its stock" do not apply to distributions to a "security holder," under section 355(a)(1)(A)(ii), but only to distributions to a "shareholder" under section 355(a)(1)(A)(i). It is subparagraph (i), and not (ii), which is applicable in this case, since taxpayers receive the stock rights as shareholders "with respect to its stock," and not as security holders "in exchange for its securities."

In rejecting the Commissioner's contention that the requirement that sixteen dollars be paid for each share of Northwest stock acquired precluded this transaction from being a distribution "with respect to its stock," the Tax Court made this observation in its opinion:

> "If Congress had intended that a distribution of the Northwest stock be treated as tax-free when made without consideration, it is inconceivable that it could have intended the transaction to result in taxable income to the distributees where they *paid out* money in connection with receiving such stock." (Emphasis in original.)

As taxpayers concede, the fundamental basis of nonrecognition of gain or loss under section 355 is that no tax should be imposed when the same people continue to own the same businesses with only formal changes in the business organization.[16] Consistent with that concept section 355(a)(1)(D) provides, in effect, that distributions made pursuant to section 355(a)(1)(A) must be made pursuant to a plan which contemplates a distribution to the shareholders of the distributing corporation of a controlling portion of the stock or securities of the controlled corporation.

Congress could well conclude that the prospect that the same people (shareholders of the distributing company) will continue to own the same business would be undermined if a distribution was effectuated by means of transferable stock rights, the exercise of which required substantial cash payments. We do not decide whether the

[16]See Treasury Regulations on Income Tax (1954 Code) § 1.355-2(c); 3 MERTENS, LAW OF FEDERAL INCOME TAXATION (Zimet and Weiss Revision), § 20.102, page 507.

transferability of stock rights would, without more, run counter to the overall concept of section 355. But when transferability is coupled with a requirement for a cash payment, it could well be that a substantial number of the distributing corporation's shareholders would, under the circumstances of a particular case, choose to sell their stock rights rather than to themselves make the cash payment which exercise of the stock rights would entail.[17]

Considered in this light, it is not at all inconceivable to us that Congress would be willing to treat a distribution as tax-free when made without consideration, but would be unwilling to so treat a distribution of assignable stock rights which requires a cash payment.

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[17]The Tax Court was of the opinion that since more than eighty percent of the shares of Northwest had been finally distributed to Pacific shareholders as of 1963, the control requirement of either (i) or (ii) of section 355(a)(1)(D) had been satisfied. However, we are not here concerned with whether, as events finally unfolded, Pacific shareholders obtained control of Northwest. Section 355 is designed to assure that, unless such retention of control is reasonably certain at the time of initial distribution, non-recognition of gain will not be effectuated. Stated differently, fulfillment of the control requisite is to be adjudged as of the date of the initial distribution rather than by recourse to hindsight in each case after the transaction has been fully consummated.

It is therefore immaterial that, in this case, taxpayers did exercise their stock rights and that, upon completion of the plan in question, more than ninety-five percent of the Northwest stock was owned by the same Pacific shareholders to whom the rights to acquire Northwest stock were distributed. This is particularly true in this case because at the time of the original distribution of fifty-seven percent of the Northwest stock in 1961, it could not be determined whether shareholders of the distributing corporation would receive a controlling amount of the stock in Northwest as required by section 355(a)(1)(D).

It is likewise without controlling significance that section 355 (a)(1)(B), quoted in note 6 above, was also perhaps designed in part to retain the business in the same ownership by disallowing this reorganization procedure of section 355 to be used as a device for distributing the earnings and profits of the distributing corporation or the controlled corporation, or both.

We therefore conclude that, as contended by the Commissioner in his first two arguments advanced on this appeal, Pacific did not distribute Northwest stock to taxpayers "with respect to its stock," as required by section 355(a)(1)(A) and, for this reason, section 355 does not excuse taxpayers from recognition of gain realized by them on the transaction in question.

The conclusion just stated makes it necessary to reverse the Tax Court decision. In addition, an independent reason for reversal is disclosed by the Commissioner's argument that Pacific did not distribute control of Northwest in a single distribution, as assertedly required by section 355(a)(1)(D).[18]

At the outset, we are confronted with the Commissioner's admission that this argument is advanced for the first time in this court. While the Tax Court was not given an opportunity to voice an opinion as to this contention, since it involves a question of law relative to facts which are not in dispute, we may and do, in the exercise of our discretion, consider this additional argument.[19]

As noted above, Pacific distributed stock purchase rights in September, 1961, and in that year distributed only

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[18]This is the third of the Commissioner's four principal arguments, as listed earlier in this opinion.

[19]In their brief in this court, taxpayers note that this argument is made for the first time on review by this court. They do not contend, however, that this circumstance precludes consideration of the argument here, and they have fully responded to the argument on the merits. The considerations for determining whether this court should allow issues to be raised which were not brought before the Tax Court are set forth in *MacRae v. Commissioner*, 9 Cir., 294 F.2d 56, 59, in which a new argument, advanced for the first time in this court was considered and found to be meritorious.

fifty-seven percent of the Northwest stock which it held. Not until almost two years later, in June, 1963, did Pacific dispose of the remaining forty-three percent of Northwest stock by making another stock purchase right offering. On the basis of these facts, the Commissioner argues that as of 1961, the tax year here in question, Pacific had failed to offer at least eighty percent of the Northwest stock, thereby violating the divestiture of control requirement of Section 355 (a)(1)(D).[20]

In support of his single distribution theory, and as an indication that section 355, by necessary implication, requires that the date of distribution of a controlling interest in the controlled corporation be a readily identifiable date at the time of the initial distribution, the Commissioner calls attention to the following: (1) both section 355(a)(1)(A) and section 355(a)(1)(D) require that the distributing corporation be in "control" of the controlled corporation "immediately before" the distribution; (2) section 355 (b)(1)(A) requires that "immediately after distribution" both the distributing and the controlled corporation must be engaged in an active business; and (3) section 355(b)(2)(B) requires that the controlled corporation business must have been conducted for a period of five years, ending on the "date of distribution." See note 6 above, for the full text of these subsections.

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[20]As is apparent from a reading of section 355(a)(1)(D), quoted in note 6 above, as part of the distribution, the distributing corporation must distribute (i) all of the stock in the controlled corporation, or (ii) an amount of stock constituting "control" within the meaning of section 368(c), 26 U.S.C. § 368(c) (1964). "Control," as defined in section 368(c), is the ownership of at least eighty percent of the total combined voting stock in a corporation and at least eighty percent of all other classes of stock of a corporation.

In answer, taxpayers in effect contend that section 355 does not require a single "distribution," but only a single "transaction," and that the two transfers of Northwest stock should be viewed as parts of a single transaction because both offerings were "contemplated and required by the plan of reorganization," which was conceived early in 1961. We have examined the exhibits submitted in the Tax Court, however, and find no requirement or general agreement that the remaining stock in Northwest would be distributed in 1963. To the contrary, the plan as explained in the "Proxy Statement" to Pacific shareholders for the 1961 offering of Northwest stock, makes it clear that the remaining shares of Northwest (forty-three percent) would be offered at a "time or times related to its (Pacific's) need for new capital."[21]

Although a "tentative schedule" set forth in Pacific's presentation of its plan does indicate that a second offering of Northwest stock might take place in December, 1962, and a final offering in December, 1963, it is obvious that such a schedule was not binding on Pacific because the only other actual offering of Northwest stock took place in June, 1963. The indefiniteness of the plan to distribute the remaining shares of Northwest is further evidenced by a recital in the Pacific plan for reorganization, to the effect that the number of shares to be offered to Pacific shareholders in any one offering, the number of offerings to be made, and the price at which these shares would be offered would be determined by the board of directors of Pacific "in its sole discretion."

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[21]The agreement entered into between Pacific and Northwest incorporated the "Proxy Statement" referred to above.

In support of their contention that a single distribution is not required under section 355, taxpayers cite several cases interpreting section 351(a), a corporate organization provision which provides in part:

> "No gain or loss shall be recognized if property is transferred to a corporation . . . by one or more persons soley in exchange for stock or securities in such corporation and *immediately after* the exchange such person or persons are in control . . . of the corporation." (Emphasis supplied.)

In *Halliburton v. Commissioner,* 9 Cir., 78 F.2d 265, summarized by this court in *Commissioner v. Schumacher Wall Board Corporation,* 9 Cir., 93 F.2d 79, 82, we held that although it took twenty-two days and two separate distributions of stock to issue the entire authorized stock of a new corporation, the pre-existing contract which provided for such an arrangement made it necessary to view the entire proceeding as a "single transaction."

Likewise, in *Portland Oil Co. v. Commissioner,* 1 Cir., 109 F.2d 479, the First Circuit noted that the transfers there involved need not be effected simultaneously, "where executed in pursuance of an *antecedent arrangement.*" (Emphasis supplied.) 109 F.2d at 488. The court pointed out, however, that such an arrangement need not be legally binding if made pursuant to a pre-existing agreement between the parties beneficially interested.

For this latter proposition, the court relied upon our decision in *Von's Investment Co., Ltd. v. Commissioner,* 9 Cir., 92 F.2d 861, in which we held that two transfers by different persons may constitute a single transaction even though the transfers were separated by a five-week inter-

val. It is critical to note, however, that this court rested its decision upon a further finding to be thereafter made by the Tax Board as to whether both transfers were made in furtherance of, and for the purpose of executing and putting into effect, the plan of reorganization embodied in an earlier contract between the interested parties.

We do not find the factual situations presented by the cases just discussed to be analogous to the circumstances of the case now before this court. In the instant case the contract between Pacific and Northwest gave no definite date upon which the remaining shares of Northwest would be distributed, and as of 1961, the time of the original distribution of Northwest stock, it was impossible to determine whether the final distribution would take place in two, three or even ten years, depending upon Pacific's need for additional capital.

Additional practical problems in the administration of section 355 would be presented if section 355 were held applicable in these circumstances. Since control could only be established after eighty percent of the Northwest stock had been distributed to Pacific shareholders, it would be impossible for the taxpayers or the Commissioner to evaluate the applicability of the particular provisions of section 355, listed above, until the time when, by subsequent distribution, the eighty percent requirement should be met. Until then, which in this case was 1963, but might just as well have been years later, taxpayers had no way of knowing whether, in computing their taxes for 1961, the benefits of section 355 were available. Likewise until then, the Commissioner would be held at bay in determining the accuracy of taxpayers' 1961 tax return.

Such an interpretation would run counter to the purpose of section 355.[22]

Taxpayers further assert that other reorganization provisions have always permitted various steps in consummating plans of reorganization as part of a single transaction. Although certain reorganizations may necessitate various steps before a reorganization may be effected, no such circumstance is presented here. It did not require the nearly two-year period which transpired in the instant case to distribute the percentage of Northwest stock required to fit within the provisions of section 355. The only apparent reason for this delay was Pacific's lack of need for additional capital at the time of the original distribution of Northwest stock.[23]

Under these circumstances, we think that a fair interpretation of section 355 requires that there be a single transaction in which a controlling interest is transferred and that for two or more distributions to be entitled to

[22]A practical problem is also posed by section 355(b)(1) and (2), which requires that the distributing corporation must have been conducted for a period of five years ending on "the date of the distribution." Since "control," as defined in section 368(c), did not pass out of Pacific's hands until the 1963 distribution of Northwest stock, this could be considered the "date of distribution." Such an interpretation, however, would allow the distributing corporation to circumvent this 355 subsection by extending the date at which final distribution of control would be completed.

[23]In its presentation of the plan in question, Pacific stated that its reasons for selling about fifty-six percent of the Northwest stock, rather than more or less were as follows: (1) to allow the parent corporation, American, to acquire more than fifty percent control of Northwest and thereby relieve Pacific of the responsibility of such control, and (2) the sale of this percentage of Northwest stock would enable Pacific to obtain the cash needed to pay off its advances from American without having excess cash left over which would have to be temporarily invested at a low return.

treatment as a single transaction transferring control of the controlled corporation to the shareholders of the distributing corporation, such distributions must not extend over any greater period of time than is reasonably necessary considering the practical problems involved in completing such distributions, apart from other considerations such as Pacific here had in mind in extending the distributions over a period of nearly two years. Applying this test, we hold that the control requirement of section 355 has not been met in this case.

In view of our conclusions reached above regarding the inapplicability of section 355 for each of the three reasons discussed, we need not consider the fourth reason advanced by the Commissioner.

In the Tax Court, taxpayers asserted several alternative arguments for the non-taxability of the distribution in question. The Tax Court did not consider and decide those alternative arguments. Since we are now rejecting the application of section 355 under the circumstances of this case, we remand the case to the Tax Court for consideration of taxpayers' alternative arguments.

Reversed and remanded for further proceedings consistent with this opinion.

Appendix D

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

Commissioner of Internal Revenue,
Petitioner,
vs.
Oscar E. Baan,
Respondent.

No. 20,863

JUDGMENT

Upon Petition to Review a Decision of The Tax Court of the United States, ...

....

This Cause came on to be heard on the Transcript of the Record from The Tax Court of the United States,

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....

.... and was duly submitted.

On Consideration Whereof, it is now here ordered and adjudged by this Court, that the ______ Decision of the said Tax Court of the United States in this Cause be, and hereby is reversed and that this cause be and hereby is remanded to the said Tax Court for further proceedings consistent with the opinion of this Court.

Filed and entered July 7, 1967

Appendix E

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

No. 214—September Term, 1966.

(Argued January 24, 1967   Decided July 26, 1967.)

Docket No. 30572

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

—v.—

IRVING GORDON and MARGARET GORDON,
Respondents.

IRVING GORDON and MARGARET GORDON,
Petitioners,

—v.—

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Before:

MOORE and FRIENDLY, *Circuit Judges;*
BRYAN,* *District Judge.*

*For the Southern District of New York, sitting by designation.

Petition for review of a decision of the Tax Court of the United States, Raum, *Judge*. The Commissioner of Internal Revenue petitions this Court to review a decision of the Tax Court that a distribution of stock to the taxpayers was governed by Section 355 of the Internal Revenue Code of 1954. Taxpayer seeks review of a decision that the sale of stock rights constituted dividend income. Opinion below reported at 45 T. C. 71. Affirmed in part and reversed in part.

MARTIN T. GOLDBLUM, Washington, D. C. (Mitchell Rogovin, Assistant Attorney General; Lee A. Jackson, Gilbert E. Andrews, on the brief), *for petitioner-respondent.*

HARRY R. HORROW, San Francisco, California (Stephen J. Martin, Pillsbury, Madison & Sutro, San Francisco, California, on the brief), *for respondents-petitioners.*

MOORE, *Circuit Judge:*

The taxpayers, Irving and Margaret Gordon (husband and wife) in 1961 owned 1,540 shares of Pacific Telephone and Telegraph Company (Pacific) common stock. Their stock certificate represented a fractional part, in theory at least, of all the assets of this company. Although collectively the stockholders owned these assets, the corporate form was not within the control of the individual stockholder but, for all practical purposes, in the control of the company's management. Therefore, when Pacific decided

to have its assets held by two corporations instead of one, the position of the Gordons remained unchanged. They merely needed to have another piece of paper to evidence their same fractional asset ownership. This, in substance, Pacific supplied. However, as a result of the transaction, the Commissioner of Internal Revenue (the Commissioner) has assessed an income tax against the Gordons who properly ask, probably in some wonderment, how this corporate change of asset ownership brought income to them and, if so, where is it?

Before considering the facts, which are not in dispute, the trite statement that an income tax should be a tax on income may serve as a beacon. All too frequently, Commissioners and courts launch into an analysis of tax sections, subsections, paragraphs and subparagraphs which practically exhaust the alphabet and Roman and Arabic numbers. In this intellectual exercise, the taxpayer often is only an incidental (though necessary) figure. Therefore, this review will be based on the principle that the ultimate question to be answered is: did the Gordons receive taxable income within the meaning of the Code because of their ownership of a Pacific stock certificate? It must be presumed that in enacting all the sections of the Code, relating to corporate changes, Congress adhered to the fundamental purpose of taxing income. The Tax Court, 45 T. C. 71, has held that they did not as to 1,536 shares; the Commissioner appeals. As to four (4) stock rights sold, the Tax Court held that income resulted and the Gordons appeal. We affirm the Tax Court as to the Commissioner's appeal and reverse as to the Gordons' (taxpayers') appeal.

The principal question presented by this petition to review the decision of the Tax Court is whether the non-recognition provisions of Section 355 of the Internal Revenue Code of 1954 can be applied to a spin-off by Pacific of a part of its assets. Pacific is a subsidiary of the American Telephone and Telegraph Company (AT&T) which at all times owned over 80% of Pacific's common stock. Prior to July 1, 1961, Pacific provided the telephone services for California, Oregon, Washington and Idaho.[1] This is a rapidly growing area of the country and for purely business reasons, Pacific decided to divide the corporation. To this end a new corporation, Pacific Northwest Bell Telephone Company (Northwest), was formed to take over the non-California business of Pacific. Pacific's management studied a variety of methods by which to effect the division, one of which was a conventional spin-off which clearly would have qualified under Section 355.[2] This method was rejected partly because

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[1]Pacific also provided telephone service in Nevada through a wholly-owned subsidiary which was not included in the spin-off here considered.

[2]Section 355 of the Internal Revenue Code of 1954 reads as follows:

"Sec. 355. Distribution of Stock and Securities of a Controlled Corporation.

(a) Effect on Distributees.

(1) General Rule.—If—

(A) a corporation (referred to in this section as the 'distributing corporation')—

(i) distributes to a shareholder, with respect to its stock, or

(ii) distributes to a security holder, in exchange for its securities, solely stock or securities of a corporation (referred to in this section as 'controlled corporation') which it controls immediately before the distribution,

(B) the transaction was not used principally as a device for the distribution of the earnings and profits of the

of state law obstacles and, presumably, partly because the AT&T family filed a consolidated tax return which eliminated intercorporate dividends and thus qualification under Section 355 was not of great importance to the corporate management. It is, however, vital to the minority Pacific stockholders and to the taxpayers

distributing corporation or the controlled corporation or both (but the mere fact that subsequent to the distribution stock or securities in one or more of such corporations are sold or exchanged by all or some of the distributees (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device),

(C) the requirements of subsection (b) (relating to active businesses) are satisfied, and

(D) as part of the distribution, the distributing corporation distributes—

(i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or

(ii) an amount of stock in the controlled corporation constituting control within the meaning of section 368(c), and it is established to the satisfaction of the Secretary or his delegate that the retention by the distributing corporation of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax,

then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder or security holder on the receipt of such stock or securities.

(2) Non pro rata distributions, etc.—Paragraph (1) shall be applied without regard to the following:

(A) whether or not the distribution is pro rata with respect to ~~all~~ of the shareholders of the distributing corporation,

(B) whether or not the shareholder surrenders stock in the distributing corporation, and

(C) whether or not the distribution is in pursuance of a plan of reorganization (within the meaning of section 368(a)(1)(D)).

(3) Limitation.—Paragraph (1) shall not apply if—

(A) the principal amount of the securities in the controlled corporation which are received exceeds the

Gordon, who owned 1,540 shares of Pacific common stock. It is their position that regardless of what the Pacific management intended, the distribution should be given the preferred tax treatment provided by Section 355.

The plan ultimately agreed upon required Pacific to transfer to Northwest all of the non-California assets and liabilities plus $110,000 in cash in return for the issuance of 30,460,000 shares of Northwest common stock and an interest bearing demand note in the amount of $200,000,-000. The result of these arrangements was to give Northwest a capital structure similar to that of Pacific. On June 30, 1961, Pacific ceased all non-California business. This

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principal amount of the securities which are surrendered in connection with such distribution, or

(B) securities in the controlled corporation are received and no securities are surrendered in connection with such distribution.

For purposes of this section (other than paragraph (1)(D) of this subsection) and so much of section 356 as relates to this section, stock of a controlled corporation acquired by the distributing corporation by reason of any transaction which occurs within 5 years of the distribution of such stock and in which gain or loss was recognized in whole or in part, shall not be treated as stock of such controlled corporation, but as other property.

(4) Cross Reference.—

For treatment of the distribution if any property is received which is not permitted to be received under this subsection (including an excess principal amount of securities received over securities surrendered), see section 356.

(b) Requirements as to Active Business.—

(1) In General.—Subsection (a) shall apply only if either—

(A) the distributing corporation, and the controlled corporation (or, if stock of more than one controlled corporation is distributed, each of such corporations), is engaged immediately after the distribution in the active conduct of a trade or business, or

(B) immediately before the distribution, the distributing corporation had no assets other than stock or securities in the controlled corporations and each of the controlled corporations is engaged immediately after

Plan, which had been accepted by the Pacific shareholders in March of 1961, further required Pacific to offer to its shareholders the right to purchase *all* of the Northwest stock held by Pacific on a pro rata basis. It was left to the sole discretion of the Pacific management, however, to determine the number of offerings of Northwest stock to the Pacific shareholders and the price at which the stock would be made available. The Plan, nevertheless, made it clear that these decisions were to be made in response to the capital requirements of Pacific and it was anticipated that all of the Northwest stock would be distributed within three years. On September 20, 1961, Pacific issued

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the distribution in the active conduct of a trade or business.

(2) Definition.—For purposes of paragraph (1), a corporation shall be treated as engaged in the active conduct of a trade or business if and only if—

(A) it is engaged in the active conduct of a trade or business, or substantially all of its assets consist of stock and securities of a corporation controlled by it (immediately after the distribution) which is so engaged,

(B) such trade or business has been actively conducted throughout the 5-year period ending on the date of the distribution,

(C) such trade or business was not acquired within the period described in subparagraph (B) in a transaction in which gain or loss was recognized in whole or in part, and

(D) control of a corporation which (at the time of acquisition of control) was conducting such trade or business—

(i) was not acquired directly (or through one or more corporations) by another corporation within the period described in subparagraph (B), or

(ii) was so acquired by another corporation within such period, but such control was so acquired only by reason of transactions in which gain or loss was not recognized in whole or in part, or only by reason of such transactions combined with acquisitions before the beginning of such period."

one transferable stock right for each outstanding share of Pacific stock. Six such rights plus a payment of $16 were required to subscribe to one share of Northwest stock, which at this time had a fair market value of $26 per share. This initial distribution involved approximately 57% of the Northwest stock held by Pacific, an amount selected in order to pass control of Northwest to AT&T immediately following the first stage of the distribution. A second and final offering, the terms of which required eight rights plus $16 to obtain one share of Northwest stock, was made on June 12, 1963, of the remaining 43% of the stock.

Pacific adopted this more complex mechanism for distribution to enable it to satisfy simultaneously its very large requirements for additional capital to finance expansion. In each annual period prior to 1961, Pacific had been required to issue common stock or debentures in an average amount of nearly 200 million dollars per year. In the three years following 1961, however, these capital requirements were satisfied through the funds received from its distribution of Northwest stock and no common stock or debentures were issued.

In response to a request by Pacific, the Commissioner issued a ruling letter prior to the first offering which concluded that the sale of the rights would produce ordinary income and that their exercise would constitute a dividend under Section 301. He further stated that Section 355 would not be applicable.

This appeal involves only the tax year of 1961. The taxpayers exercised 1,536 of the 1,540 rights they received

that year. On their income tax return, the taxpayers took the position that this aspect of the transaction was not subject to tax and therefore reported no gain or loss. The other four rights were sold for a total amount of $6.36, which was reported as a capital gain. On July 19, 1963, the Commissioner assessed a deficiency of $895.10 based on these transactions.

I.

It is not disputed that the Pacific-Northwest corporate division fulfilled a valid business purpose. Nor is it disputed that the method selected by Pacific to accomplish this division was dictated by valid business reasons. In fact, it does not appear to be disputed that there was no possibility under this transaction for turning ordinary income into capital gains—the evil which Section 355 was designed to prevent. Rather, the government contends that in a number of technical respects, the requirements of that Section were not met and that, therefore, the distribution of Northwest stock must be treated as a dividend. While the government raises a number of purely technical questions to which we shall shortly turn, the truly decisive question before this Court is how Section 355 shall be construed. The taxpayers argue that Section 355 is the embodiment of a Congressional decision that corporate divisions are desirable as a matter of public policy and should not be impeded by tax considerations. Congress recognized, of course, that corporate divisions are a perfect vehicle for bail-outs of earnings and profits and, therefore, hedged in the use of Section 355 with a number of conditions which must be met. But when the division presents no opportunity for a bail-out, these con-

ditions should not be so construed as to frustrate the basic Congressional purpose. The Commissioner, for his part, argues that Section 355 is merely a tax concession granted by Congress to permit certain narrowly defined transactions. He concludes that, as with all such privileges, the statute is to be narrowly construed.

In evaluating the jurisprudential philosophy of the government, we are not required to limit our search to the instant case in which it serves the Commissioner's purpose to argue for a narrow construction. Initially, we note the long line of cases holding that mere compliance with the reorganization sections does not ensure a tax-free exchange if there is lacking a business purpose or, perhaps, a continuity of interest in the transaction. See, e.g., *Gregory v. Helvering*, 293 U. S. 465 (1935), *Bazley v. Commissioner*, 331 U. S. 737 (1947). While, obviously, the converse of this proposition is not true, these cases properly stand for the proposition that in determining tax results, the courts do not merely look to the literal language of the statute but also view the business transaction as a whole in conjunction with the underlying purpose of the taxing statute. We are not aware of any rule of law that preserves such a salutary tenet of construction for the exclusive benefit of the Commissioner. See *Helvering v. Alabama Asphaltic Limestone Co.*, 315 U. S. 179 (1942).[3]

[3]In sustaining the contention of the taxpayer that a reorganization had occurred, the Court stated:

> "Some contention, however, is made that this transaction did not meet the statutory standard because the properties acquired by the new corporation belonged at that time to the committee and not to the old corporation. That is true. Yet, the separate steps were integrated parts of a single scheme.

Furthermore, we note that the Commissioner has not always taken such a constricted view of the reorganization sections. When it serves his purpose, the Commissioner has argued that when a reorganization has in fact occurred, it should be taxed under the reorganization sections of the Code even though the strict requirements of the statute have not been met. See, e.g., *Gallagher v. Commissioner,* 39 T.C. 144 (1962); *Berghash v. Commissioner,* 43 T.C. 743 (1965), *aff'd* 361 F. 2d 257 (2 Cir. 1966).

While we think it beyond dispute that the courts are permitted a certain flexibility in applying the Code, it should be added that cases in which the courts must stray from the literal language of the Code in order to achieve its underlying objectives will not be frequent. Conversely, however, undermining the general purposes of the Code through an overly literal application of each of its technical provisions cannot be justified. Here it is evident that the taxpayers' investment remained in corporate solution (aside from the $6.36) and merely changed its form. The only additional factor was the payment of $16 per share which was in reality tantamount to a contribution to capital and that, of course, is no occasion for the imposition of a tax. Nor was there any opportunity for the taxpayers to use this transaction for a bail-out of earnings and profits. On the other hand, if the Commissioner prevails,

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Transitory phases of an arrangement frequently are disregarded under these sections of the revenue acts where they add nothing of substance to the completed affair. *Gregory v. Helvering,* 293 U. S. 465; *Helvering v. Bashford,* 302 U. S. 454. Here they were no more than intermediate procedural devices utilized to enable the new corporation to acquire all the assets of the old one pursuant to a single reorganization plan." 315 U. S. at 184-85.

taxpayers' equity investment will be turned into ordinary income.

Wholly aside from these considerations of a general nature, an examination of the specific objections made by the Commissioner reveals that at the maximum, this division strayed from the literal terms of Section 355 in only very minor respects.

A. *"Distributes . . . with respect to its stock."*

From the taxpayers' point of view, they found themselves holding two pieces of paper, a certificate for 1,540 shares of Pacific, and a certificate for 1,540 rights, which when exercised, together represented their ownership in Pacific's assets, including a $16 capital contribution, certainly not an income-producing act. They were neither richer nor poorer. Neither the receipt of the rights certificate and its exercise nor the capital contribution produced any income to them. The Tax Court quite properly observed that

> "If Congress had intended that a distribution of the Northwest stock be treated as tax-free when made without consideration, it is inconceivable that it could have intended the transaction to result in taxable income to the distributees where they *paid out* money in connection with receiving such stock." (Emphasis in original.) 45 T. C. 71.

Subsection (a)(1)(A)(i) requires that the stock of Northwest be distributed by Pacific with respect to the Pacific stock. The Commissioner argues that in fact Pacific distributed only stock rights with respect to its stock and that the Northwest stock was exchanged for six

rights, which could have been purchased through the market by anyone and $16 and, thus, qualification under Section 355 is barred because a distribution of stock rights does not satisfy the statute. We think the result contended for by the Commissioner is precluded by *Palmer v. Commissioner,* 302 U. S. 63 (1937) and *Choate v. Commissioner,* 129 F. 2d 684 (2 Cir. 1942). Normally, the distribution of a stock right has no tax consequences because there is no distribution of corporate property until the right is exercised.[4] A sale or exchange of a stock right prior to exercise results in a tax only because it is an anticipation of gain from an exercise. It follows in this case that it is the actual distribution of the Northwest stock upon the exercise of the rights that is the relevant event and the use of the stock rights as a mere mechanism to accomplish this result should be disregarded. Compare *Kimbell-Diamond Milling Co. v. Commissioner,* 14 T. C. 74 (1950), *aff'd,* 187 F. 2d 718 (5 Cir. 1951); *Heller v. Commissioner,* 2 T. C. 371 (1943), *aff'd,*. 147 F. 2d 376 (9 Cir. 1945).

Secondly, the Commissioner argues that the phrase "distribution . . . with respect to its stock" is a term of art that excludes the use of a cash consideration such as the $16 required here. He cites no authority for this proposition and we are aware of none. It is perfectly obvious that the Code does not contemplate the receipt of cash by a corporation in connection with a distribution with respect to its stock in the sense that some specific section of the Code spells out the tax result. See Sections 311(a)

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[4]Possible exceptions such as Section 305(b) have no application to the instant transaction.

and 312(d). But it scarcely follows that the Code prohibits the receipt of cash or that if the instant transaction is classified as falling within Section 355, the tax consequences cannot be determined. The only additional factor present is the payment of the $16 and that can be treated very simply as a contribution to capital by a shareholder. However, this question is not before us.[5]

The ultimate question before us is whether, when a reorganization is coupled with another transaction, these two transactions can, or should, be re-separated for federal income tax purposes. When it suits the Commissioner's convenience, he has so argued. See, *e.g.*, Rev. Rul. 61-156, 1961-2 C. B. 62; Regulations 1.301-1(e) and 1.331-1(c). And if the Code is to conform as closely as possible to economic reality, such a division should be performed when necessary. Of course, if the coupling itself is promotive of the evils which the taxing statute was designed to prevent, a separation for tax purposes should not be made for then the taxpayers would have obtained the best of all possible results to the prejudice of the fisc. Here the Tax Court concluded that no conceivable purpose would be served by denying tax-relief when the taxpayer paid out cash while such relief was granted absent this expense. The Commissioner answers the Tax Court by arguing that the use of transferable stock rights plus the $16 requirement "predictably will diminish the continuity of ownership." Thus the Commissioner invokes the judicial gloss on the reorganization sections that, with some exceptions, continuity of interest

[5]Although Pacific appears to have treated the cash obtained from the minority stockholders as gain from the sale of property, that is no bar to these taxpayers.

must be maintained. The short answer to this argument is that it was. The doctrine of continuity of interest has never to our knowledge been used to void a reorganization on the ground that some shareholders might have sold their stock. Indeed, such a rule would void each and every attempted reorganization for with rare exceptions, stock can always be sold as Congress expressly permitted in Section 355(a)(1)(B). Rather, this limitation is applied to the actual result of a transaction: was a continuity of interest in fact maintained? Here over 95% of the shareholders in Pacific before 1961 exercised their rights and became shareholders in Northwest. Further, AT&T itself owned over 80% of the Pacific stock and after the division owned over 80% of both Pacific and Northwest. The doctrine of continuity of interest asks no more.[6]

B. *"Transaction in which gain or loss was recognized."*

The Commissioner further takes the position that qualification under Section 355 is barred by the requirement of Section 355(b)(2)(C) that the trade or business which is being actively conducted by either the controlled or the distributing corporation was not acquired in a transaction in which gain or loss was recognized. Taxpayers argue and the Tax Court agreed that because any

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[6]In *Commissioner v. Baan*, ... F. 2d ...... (9 Cir. 1967), which arose out of the same corporate division and was decided by the Tax Court with the instant case, it was held that the requirements of Section 355 had not been met. One of the principal grounds of that decision was that while the mere use of stock rights may not preclude a tax-free division, the added condition of a $16 payment barred the application of Section 355 because of the danger that a continuity of interest would not be maintained.

gain or loss on the intercorporate transaction was eliminated on the consolidated tax return of these affiliated corporations, this condition of the Section was satisfied. Analysis of the purposes underlying subsections (b)(2) (C) and (D) prohibits acceptance of this conclusion because the happenstance of affiliation does not remove the danger of purchasing a corporation for the purpose of distributing its stock as a dividend while avoiding the tax on dividends. However, this same analysis of the statute indicates clearly, we think, that 355(b)(2)(C) has no application to this case. The theory underlying 355(b), the active business requirement, is the prevention of the temporary investment of liquid assets in a new business in preparation for a 355(a) division. The primary danger envisioned by the draftsmen of this Section was the creation of the new business and the safeguard was the five-year provision. The reasoning is that if the new business must be operated for at least five years, there will be little incentive to use this device for tax avoidance purposes. The second danger was that instead of creating a new business, the corporation would purchase one which had been in existence for over five years and then distribute its stock in place of a dividend. To safeguard against this possibility, subsections (b)(2) (C) and (D) prohibit acquisition of a trade or business, or of a corporation, in a transaction in which gain or loss was recognized. In our case no new business, no new assets and no new corporation was acquired at all. No liquid assets were temporarily invested nor, in fact, was there any temporary investment. Consequently, the application of these sections to the instant transaction

would serve no purpose at all. We think that the draftsmen of Section 355 intended these subsections to apply only to the bringing of new assets within the combined corporate shells of the distributing and the controlled corporations. Therefore, it is irrelevant in this case whether gain was recognized on the intercorporate transfer.

C. *Single Distribution.*

Finally, the Commissioner argues that there is an implied requirement in Section 355 that the distribution of stock take place in a single offering and since Pacific utilized two offerings separated by almost two years, the statutory requirement has not been met. It is conceded that there is no direct authority for this proposition but the Commissioner argues that such a result is demanded by the scheme of Section 355. In particular, he refers to subsection (a)(1)(D) which reads as follows:

> (D) as part of the distribution, the distributing corporation distributes—
>
> (i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or
>
> (ii) an amount of stock in the controlled corporation constituting control within the meaning of section 368(c), and it is established to the satisfaction of the Secretary or his delegate that the retention by the distributing corporation of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax,

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On its face, this subsection is simply the embodiment of the Congressional decision that only complete, and not partial, divisions were to receive tax-free status and its purpose seems limited to establishing the amount of stock which must be distributed for qualification under Section 355. Both subdivisions require that the distributing corporation distribute an amount of stock in the controlled corporation constituting control. Subdivision (D)(i) imposes the additional requirement that the distributing corporation distribute all of the stock held "immediately before" the distribution to its shareholders, even if that amount is less than all of the outstanding stock. The quoted language in no way requires a single distribution but is merely the means used to permit distribution of less than all of the outstanding stock in the controlled corporation. Alternatively, the corporation may proceed under (D)(ii) which permits retention of stock to a limited degree. Permitting retention at all is a departure from prior law and from the Congressional policy of complete division at the corporate level. To prevent abuse, Congress added to this subdivision a requirement that the taxpayer affirmatively demonstate the absence of tax avoidance objectives instead of requiring the Commissioner to move under subsection (a)(1)(B). Here again, the fact that Congress permitted limited retention after the completion of the distribution cannot be said to imply that the distribution must have but a single phase. Thus there is nothing on the face of this subsection that relates to the number of transactions, or their timing, which may be contained in a distribution. These matters are entirely governed by the more flexible "device" clause

of Section 355(a)(1)(B) which is fully adequate for this purpose and which clearly is no bar to the qualification of this corporate division. As there is no dispute that in both the original plan and in the fact a complete division occurred, applying the statute in this, the most obvious, manner and giving its words their everyday import compel the conclusion that subsection (a)(1)(D) was satisfied.

The Commissioner, however, contends that the requirements of subsection (a)(1)(D) "undoubtedly" were designed to prevent periodic distributions of stock in the controlled corporation as a substitute for dividends. The only authority for this proposition is Professor Bittker who, in discussing the requirement of explaining retention to the Secretary, "presumes" this purpose. But Professor Bittker was not addressing himself to the question of a single distribution and the Commissioner omits to cite his further observation in the same paragraph that such an abuse would clearly be prohibited by subsection 355(a)(1)(B), the "device" clause, and thus if that is the purpose of the subsection, it is redundant. He further notes that there does not appear to be any necessity for the provision in any event. Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders 479 (2 Ed. 1966). Another commentator states that the requirement of subsection (a)(1)(D) "is designed to differentiate between genuine separations and incidental distributions of a controlled corporation's stock which take the place of current cash dividends." Surrey & Warren, Federal Income Taxation 1640 (1962). The Commissioner does not suggest that the instant transaction was not a genuine

division nor could it conceivably be considered a substitute for a current dividend.

Whether a corporation has retained stock or distributed it is simply a question of the point in time that the manipulation is examined. The Commissioner argues that this point is immediately after the first transaction and that subsection (a)(1)(D)(ii) prohibits "retaining" over 20% of the stock after this point. The taxpayers argue that the time is after the culmination of the plan of distribution and that subsection (a)(1)(D)(ii) only prohibits an indefinite retention.[7] On its face Section 355 gives little guidance but we do know that neither of the purposes suggested for subsection (a)(1)(D) will be defeated by permitting more than one distribution and that the construction of that provision for which the Commissioner argues does not fit easily within its language. But an adequate restriction is already provided by subsection (a)(1)(B).

Further, the incongruity of the result urged by the Commissioner when viewed against other provisions of the Code creates considerable doubt that Congress would intentionally require a single distribution. In 1961 Pacific was the eighth largest non-financial company in the United States and had over 38,000 shareholders. The reorganization resulted in a distribution of over 30 million shares of Northwest stock and raised for Pacific nearly one-half billion dollars. A requirement that such a trans-

[7] While the Plan adopted by Pacific theoretically might have permitted this, the surrounding facts make it certain, as found below, that long-term retention was never intended and, of course, was not the fact. In the future, it would be preferable that such plans set out the timetable of distribution more precisely, as undoubtedly the Commissioner will require.

action occur on a single day would be staggering. As far as this Court is aware, none of the other reorganization sections impose such a requirement, aside from the highly limited scope of *Bausch & Lomb Optical Co. v. Commissioner,* 276 F. 2d 75 (2 Cir. 1959), which is not relevant here. Regulations 1.368-2(c); Rev. Rul. 58-93, 1958-1 C. B. 188. See also Sections 332(b) and 337(a).

As it is fairly apparent that neither the Code nor the Regulations require, at least by their terms, a single distribution, such a requirement cannot be read into the Code, at least without a substantial reason. A fair reading of the Commissioner's brief indicates that he fears two problems from the result reached below. First, he suggests the danger of periodic distributions as a substitute for dividends and the tax avoidance that this would permit. But as we have noted, it is not clear that there are tax avoidance possibilities in such a scheme so long as the active business requirements are met; if they could be shown to exist, the "device" clause would prohibit any bail-out.

Second, the Commissioner points to a number of administrative difficulties inherent in permitting more than a single distribution such as leaving open the tax result for several years, the problem of defining the "date of distribution," and the difficulty in ascertaining whether there was control "immediately before" the distribution.[8]

[8]The fact that the two transactions which we hold constituted a single distribution occurred in different tax years is of no significance. Had the transactions occurred in January and December of 1961, we would be faced with the same questions as this case presents. The Commissioner makes no point of the fact that two tax years are involved, nor could he. See *Pridemark, Inc. v. Commissioner,* 345 F. 2d 34 (4 Cir. 1965).

But the facts of this case can hardly be said to create the insurmountable administrative difficulties which the Commissioner has paraded before us in his brief. Here only two transactions occurred covering a maximum of three tax years. In fact, the deficiency notice in this case was not sent until July of 1963, two months after the second distribution was authorized. The Commissioner attacks the Tax Court by asserting that its opinion would permit ten distributions of 10% of the Northwest stock, an assertion most doubtful in itself for it overlooks the impact of subsection (a)(1)(B). But that is not our case and it can scarcely be contested that the Code imposes a tax on facts, not expectations. Perhaps the enormity of the administrative difficulties may be measured in part by the failure of the Commissioner to raise the single distribution point in the Tax Court.[9]

Conceding that some administrative problems will arise from our decision, they hardly provide a justification for denying tax-free reorganization status to a legitimate spin-off that entails none of the tax avoidance features that Section 355 was designed to prevent. In any event, we think it is the task of the Commissioner to resolve these difficulties, not the courts'. Nothing in our opinion prevents the Commissioner from drafting reasonable Regulations limiting the time period within which the entire dis-

[9]In *Commissioner v. Baan, supra,* the Ninth Circuit alternatively held that while a single distribution was not required by subsection (a)(1)(D), because of the difficulties in administration, "such distributions must not extend over any greater period of time than is reasonably necessary considering the practical problems involved in completing such distributions." While this approach effectively compromises the harshness of the Commissioner's argument, the statute contains no such requirement.

tribution must be made, or the number of transactions which may be involved, or specifying what advance notice must be provided the Service, or defining the statutory language quoted above. But we are not prepared to apply retrospectively restrictions directed at evils which this case does not present.

The decision of the Tax Court on the Commissioner's petition is affirmed.

II.

Four of the stock rights issued by Pacific were sold by taxpayers for a total amount of $6.36. The Tax Court determined that aside from the effect of Section 355, this distribution by Pacific would be taxable as a dividend. The Court further held that Section 355 could have no application until there had actually been a distribution of stock and, thus, where the rights were disposed of prior to exercise, Section 355 had no application. Such an asymmetrical approach to Section 355 is untenable.

It is well settled that the exercise of a stock right may result in dividend income if the fair market value of the acquired stock exceeds the option price. *Palmer v. Commissioner,* 302 U. S. 63 (1937); *Choate v. Commissioner,* 129 F. 2d 684 (2 Cir. 1942). And since the sale of a right may be an anticipatory realization of dividend income, gain on the sale is similarly taxed at ordinary income rates. *Helvering v. Horst,* 311 U. S. 112 (1940), *Gibson v. Commissioner,* 133 F. 2d 308 (2 Cir. 1943). However, in a transaction to which Section 355 applies, the distribution of stock by a corporation does not result in a dividend even though the distribution was accomplished by the use

of stock rights and the option price was less than the fair market value of the acquired stock. The assumption of such cases as *Palmer* and *Gibson* is that a distribution of corporate earnings results from the existence of a "spread." Section 355, on the other hand, is a statutory device for determining that a distribution of capital, rather than of earnings, has occurred and therefore the assumption of those cases is inapplicable. The reasoning of *Gibson,* however, that the sale of a stock right should be taxed the same as an exercise is controlling. Similar reasoning exists in Code Section 1234(a). And see *Rank v. United States,* 345 F. 2d 337 (5 Cir. 1965). Since the gain on an exercise of these rights, although deferred until the sale of the stock, would be capital, we hold that the sale of the rights similarly gave rise to capital gains. The error of the Tax Court was in forgetting that it is not the individual shares of stock received by these taxpayers that qualify under Section 355 but the entire distribution by Pacific.

The decision of the Tax Court on the taxpayers' petition is reversed.

FRIENDLY, *Circuit Judge* (dissenting):

If in 1962 a revenue agent had reviewed the Gordons' 1961 return which, as stipulated, "did not include as income any amount with respect to the sale of rights to purchase Northwest stock or with respect to the exercise of rights to purchase Northwest stock or with respect to the receipt of such stock," he would have been justified in thinking his task was an easy one, at least so far as con-

cerns the point here decided in favor of the taxpayers. Tender of six such rights plus $16 permitted the purchase of a share of Northwest stock at well below market price.[1] Despite the majority's belief that stockholders realize no income simply because of the receipt of "another piece of paper to evidence their same fractional ownership," *Palmer v. C. I. R.*, 302 U. S. 63 (1937), as interpreted by this court in *Choate v. C. I. R.*, 129 F. 2d 684 (2 Cir. 1943), taught that the sale of exercise of the Pacific rights was dividend income unless some section of the 1954 Internal Revenue Code dictated otherwise. Examining §355, the section held by my brothers to afford a tax shelter, the agent would have encountered subdivision (a)(1)(D), which requires that:

> "as part of the distribution, the distributing corporation distributes—
>
> (i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or
>
> (ii) an amount of stock in the controlled corporation constituting control within the meaning of section 368(c), and it is established to the satisfaction of the Secretary or his delegate that the retention by the distributing corporation of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax.".

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[1]During the offering period the price of the Northwest shares ranged from $28.25 to $25.25. In determining the value of the rights and consequent dividend income the Commissioner used $26, the average price on October 5, 1961, the day the Gordons exercised their warrants. Taxpayers make no claim that the value of the rights on the day of receipt was less than the amount thus determined.

He would readily have ascertained that Pacific had not met the test of clause (i) since, far from having distributed all the Northwest stock "held by it immediately before the distribution," it retained 13,013,969, approximately 43% of the total of 30,460,000 shares. By the same token Pacific had not complied with clause (ii); the 57% of the stock distributed was nowhere near the 80% "constituting control within the meaning of section 368(c)." If Mr. Gordon had displayed Pacific's letter of February 27, 1961, requesting stockholder assent to the plan and advising "It is expected that within about three years after acquiring the stock of the New Company [Northwest], the Company [Pacific] by one or more offerings will offer for sale the balance of such stock, following the procedure described in the preceding paragraph," the agent could have replied that §355 is concerned with acts rather than expectations. He might also have repeated Mr. Justice Stone's oft-quoted statement, as true today as when written: "All the revenue acts which have been enacted since the adoption of the Sixteenth Amendment have uniformly assessed the tax on the basis of annual returns showing the net result of all the taxpayer's transactions during a fixed accounting period, either the calendar year, or, at the option of the taxpayer, the particular fiscal year which he may adopt." *Burnet v. Sanford & Brooks Co.*, 282 U. S. 359, 363 (1931). The agent would therefore have been obligated to recommend the determination of a deficiency, so far at least as §355 was the basis asserting for the taxpayers' return, and this without even having to consider the Commissioner's basic claim, recently sustained by the Ninth Circuit, *C. I. R. v.*

Baan, ——— F. 2d ——— (1967), that a distribution of rights to purchase the stock of a controlled subsidiary at less than its fair value is not within §355(a)(1)(A).

If a court would have sustained the agent in litigation during 1962, as it seemingly would have had to do, I fail to perceive how Pacific's action in ridding itself of the remaining Northwest shares in 1963 can justify a different result. The 1961 taxes of the Gordons and other minority stockholders depend on what Pacific did in 1961, not on what it chose to do in 1963. *Burnet v. Sanford & Brooks Co., supra; see also Healy v. C. I. R.*, 345 U. S. 278, 281 (1953). When Congress has meant the events of one year to affect the tax for another, it has said so in language all can understand. See, e.g., §§172(b), 381, 382, 1301, 1302, 1303. Although the plan adopted by Pacific in 1961 committed it to offer its shareholders "the right to purchase all of the shares of capital stock of the New Company," the plan also provided, subject to an exception not here material, that "the number of shares to be offered to the shareholders of the Pacific Company in any one offering, the number of offerings to be made, and the price at which said shares shall be offered to the shareholders of the Pacific Company shall be determined by the Board of Directors of the Pacific Company in its sole discretion." The qualification was so broad as to deprive the commitment of legal significance, and while in fact the second distribution occurred within 21 months, it is not difficult to think of circumstances, such as adverse regulatory action or restrictions on the procurement of telephone plant due to national emergency, that might have postponed Pacific's need for funds and consequent further

distribution of Northwest stock for many years. Moreover, if the 1961 distribution of some 57% of the stock can be metamorphosed into a distribution of 100% by what occurred two years later, I assume my brothers would also give the 1963 distribution of 43%, which clearly would not qualify on its own since Northwest was not then a "controlled corporation" within §355(a)(1)(A), see §368(c), the color now attributed to its predecessor. Furthermore, under my brothers' view that a corporation satisfies §355(a)(1)(D) if it ultimately rids itself of all the stock of the controlled corporation, the shelter of §355 would extend to a 1961 Pacific stockholder who sold his stock before 1963 and to a 1963 stockholder who had not owned Pacific stock in 1961. How this jibes with the recognized purpose of §355 to give tax-free treatment where there is "a continuity of the entire business enterprise under modified corporate forms and a continuity of interest in all or part of such business enterprise on the part of those persons who, directly or indirectly, were the owners of the enterprise prior to the distribution," Regulations §1.355-2(c), passes my understanding.

The inspiration for the magic whereby two distributions of 57% and 43% in different years become one of 100% is my brothers' belief that at the end of the process the position of most Pacific stockholders with respect to Northwest shares they had acquired had changed only in their having paid $16 per share to retain what they had owned all along, a feeling—which I share—that the instant transaction was motivated by business considerations and not by a desire for tax avoidance, and an apparent view that §355(a)(1)(D) was an unnecessary

or at least a redundant requirement. Yet the stockholders' investment status would also have been unchanged and the Company's motive equally pure if Pacific had never made the second distribution or if Northwest had been only 79% owned from the outset, and, despite the majority's apparent distaste for the view that distribution of rights to purchase corporate property below market value normally constitutes a dividend, I cannot imagine any court would consider that in such event rights offerings like those here made by Pacific were protected by §355.

Congress has simply not seen fit to exempt all distributions where stockholders' investments remain unchanged from a practical standpoint and no tax avoidance motive is manifest; instead it has chosen to lay down extremely specific conditions which a corporation must follow at its peril if it desires to achieve nonrecognition for its stockholders. Complicated tax statutes particularly invite application of Mr. Justice Holmes' precept, "Men must turn square corners when they deal with the Government," *Rock Island, Ark. & La. R.R. v. United States,* 254 U. S. 141, 143 (1920). In §355(a)(1)(D) Congress elected to convert a vague guideline contained in the Regulations under the 1939 Code that "Ordinarily, the business reasons (as distinguished from any desire to make a distribution of earnings and profits to the shareholders) which support the reorganization and the distribution of the stock will require the distribution of all of the stock received by the transferor corporation in the reorganization," Regs. §39.112(b)(11)-2(c), into a specific statutory requirement: Distribute all at once with no questions

asked, or, if you prefer, distribute not less than 80% of the stock of the controlled corporation and satisfy the Commissioner that any retention was not for a forbidden purpose. When Pacific chose not to comply for what it considered valid business reasons, its stockholders must take the consequences.

The Supreme Court has pertinently instructed us to approach revenue acts with the attitude that "the plain, obvious and rational meaning of a statute is always to be preferred to any curious, narrow, hidden sense that nothing but the exigency of a hard case and the ingenuity and study of an acute and powerful intellect would discover." *Old Colony R.R. v. C. I. R.*, 284 U. S. 552, 560 (1932), citing *Lynch v. Alworth-Stephens Co.*, 267 U. S. 364, 370 (1925). It has also told us that "the words of statutes—including revenue acts—should be interpreted where possible in their ordinary, everyday senses," *Crane v. C. I. R.*, 331 U. S. 1, 6 (1947); *Hanover Bank v. C. I. R.*, 369 U. S. 672, 687 (1962). A requirement that a corporation distribute all of a controlled corporation's stock held by it "immediately before the distribution," when read against the basic concept of annual tax accounting, can only mean to distribute all at one time[2]—not to distribute 53% and plan to distribute the rest in a later year or years when and as that suited.[3] With all respect, my brothers seem to be emulat-

[2] It is setting up a straw man to suggest that this means that the mechanics of a large distribution must be fulfilled "in a single day."

[3] There is the further point, noted in Judge Hamley's able opinion in *Baan, supra*, ... F. 2d ......, ... n. 22, that the concept of *seriatim* distributions might often be inconsistent with the requirement of §355(b)(1)(A) and (2)(B) that the distributing and controlled corporations shall have actively conducted a trade or business "throughout the 5-year period ending on the date of such distribution."

ing Humpty Dumpty when they say that the words of the statute in "their everyday import" authorize such a course,[4] and that the only basis for believing the words mean what they say is the view of a distinguished professor, now endorsed by another court of appeals, who, while thinking that Congress could have been more liberal without seriously affecting the revenue, recognized that "Whatever the validity of the reasons for its existence, §355(a)(1)(D) must of course be complied with." Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders §11.07 at 479 (1966). And we do not satisfactorily answer the Commissioner's claim of administrative difficulties by chiding him for failure to have promulgated regulations that would partially seal up the breach in the statute we are attempting to create today. Unless the words used by Congress lead to absurd results, are inconsistent with its apparent purpose, or are filled by history with a meaning different from the ordinary one, none of which can be successfully asserted here, a court's job is to apply what Congress has said.

Since I am in full accord with the Ninth Circuit that Pacific's decision to bypass the requirement of §355(a)(1)(D) prevents §355 from immunizing the income realized on the exercise of the rights,[5] I find it unnecessary to decide

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[4]This comment applies also to such statements as that "The quoted language in no way requires a single distribution," that "there is nothing on the face of this subsection that relates to the number of transactions, or their timing, which may be contained in a distribution," and that "it is fairly apparent that neither the Code nor the Regulations require, at least by their terms, a single distribution."

[5]Taxpayers' arguments based on decisions under predecessors of §351(a) are answered in the opinion in *Baan, supra,* ...... F. 2d at ....

whether that court or the instant majority is right as to the transaction's meeting the basic test, §355(a)(1)(A), of being a distribution solely of stock or securities of a controlled corporation with respect to stock of the distributing corporation. Certainly the words have an uneasy fit to the transaction here in question. What Pacific distributed "with respect to its stock" was not "solely stock or securities" of a controlled corporation but rights to purchase such stock below market price, and the stock of the controlled corporation was distributed "with respect to" the rights rather than the Pacific stock. But even if the distribution of Northwest stock qualified under §355, I could not agree to reversal of the Tax Court's decision that the proceeds of the sale of rights to purchase Northwest stock constituted ordinary income. *Palmer v. C. I. R., supra,* along with *Choate v. C. I. R.,* 129 F. 2d 684 (2 Cir. 1943), and *Gibson v. C. I. R.,* 133 F. 2d 308 (2 Cir. 1943), instruct us that the value of the rights on receipt would be taxable as ordinary income upon their exercise or sale but for some exemptive provision in the Code. Vaulting the language barriers that seem to prevent the issuance of Northwest stock on the exercise of rights from coming within §355, would not help Pacific's stockholders as to rights they sold. As Judge Raum correctly said, the argument "fails to take into account the nature of Section 355, which is a nonrecognition provision, and can be utilized only by those shareholders who come within its terms"—namely, on the majority's view, shareholders who received a distribution of Northwest stock "in respect of" their Pacific stock. The majority's references to §1234 and to *Rank v. United States,* 345 F. 2d 337 (5 Cir. 1965), are inappo-

site; what is here sought to be taxed is the initial value of the rights, not a gain on their sale. Taxpayers argue that the Tax Court's holding creates an unjustifiable distinction between a stockholder who sells rights to purchase stock of a controlled corporation and one who sells the stock of the latter on a when-issued basis and exercises rights to cover the sale. But "the Commissioner is justified in determining the tax effects of transactions on the basis in which taxpayers have molded them," *Television Industries, Inc. v. C. I. R.,* 284 F. 2d 322, 325 (2 Cir. 1960). Moreover, the actual answer may well be that, for reasons heretofore noted, neither the real nor the hypothetical taxpayer is entitled to the benefit of §355.

On the Commissioner's appeal I would reverse the decision as to §355 and remand for consideration of the other grounds advanced by the taxpayers and not dealt with by the Tax Court; on the taxpayers' appeal I would affirm.

In the Supreme Court
OF THE
United States

OCTOBER TERM, 1967

No. 760

COMMISSIONER OF INTERNAL REVENUE, *Petitioner*

v.

IRVING GORDON and MARGARET GORDON, *Respondents*

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

MEMORANDUM FOR RESPONDENTS

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MEMORANDUM FOR RESPONDENTS

Respondents ("taxpayers"), agree with the statement of facts in the petition. However, in setting forth the questions presented (Pet., p. 2), petitioner has implied that the 1961 issuance of the Northwest rights by Pacific to its shareholders was a transaction separate from the issuance of the Northwest rights by Pacific to its shareholders in 1963. The Tax Court expressly found as a fact, not challenged by petitioner on review before the court below, that the two offerings of the Northwest stock were component parts of a single plan and that they must

be regarded together as resulting in the disposition of 100 per cent of the Northwest stock in a single transaction (45 T.C. 71, 87). The question properly stated then is whether, under section 355 of the Internal Revenue Code of 1954, taxpayers received their stock in Northwest as part of a non-taxable spinoff distribution by Pacific of all of the stock of Northwest, a controlled corporation, as held by the Tax Court, and the court below.

The second question presented here is whether the court below properly ruled that the proceeds of sale of the rights were taxable as long-term capital gains, rather than dividend income, as held by the Tax Court.

The instant case and the *Baan* case (Oct. Term, 1967, No. 781) were two test cases instituted in the Tax Court to challenge the validity of ruling letters issued by the Commissioner of Internal Revenue that the receipt of the Northwest stock by noncorporate shareholders of Pacific, through the exercise of rights under the plan of reorganization referred to, gave rise to dividend income equal to the difference between the amount paid in exercise of the rights and the value of the Northwest stock at the date of exercise. In addition, in the *Gordon* case, the taxpayers challenged the ruling of the Commissioner that the sale of such rights gave rise to ordinary income rather than capital gain.

There were approximately 25,000 noncorporate shareholders of Pacific adversely affected by these rulings. The two cases were tried on identical records and consolidated for trial and opinion in the Tax Court, which held that no taxable income resulted under section 355 from the exercise of rights to acquire Northwest stock. Over 95

per cent of the shareholders in Pacific before 1961 exercised their rights and became shareholders in Northwest (Pet., p. 22). If all of the Northwest stock had been distributed by Pacific to its shareholders without the payment of cash by them, the transaction would clearly have qualified as a classic divisive tax-free reorganization under section 355. The Tax Court found it inconceivable that Congress could have intended that under section 355 the receipt of Northwest stock by the Pacific shareholders would be taxable, where the shareholders were required to contribute to the capital of Pacific as a condition to receiving the Northwest stock. The Tax Court also ruled contrary to the Commissioner on the tax treatment of the sale of rights, holding that the proceeds of the sale of the rights were taxable as dividend income. The Second Circuit Court of Appeals decided both issues in favor of the taxpayers, Judge Friendly dissenting. The decision of the Second Circuit Court of Appeals was handed down on July 26, 1967, after the Ninth Circuit Court of Appeals had decided the *Baan* case in favor of the Commissioner, reversing the Tax Court. The decision of the Second Circuit Court of Appeals, therefore, is in direct conflict with the decision of the Ninth Circuit Court of Appeals in the *Baan* case.

Section 355 is a comprehensive statutory provision designed to deal in one section with so-called divisive corporate reorganizations whether they take the form of split-offs, split-ups or spinoffs. This section involves corporate reorganizations of considerable magnitude, and the questions involved, on which the Ninth Circuit and Second Circuit are in disagreement, are novel and continuing. In

addition, the tax treatment of the sale of rights involves important questions in the application of the landmark decision in *Palmer v. Commissioner* (1937) 302 U.S. 63. These questions on the tax treatment of the sale of rights are interrelated with the tax problems involved as to whether the exercise of the rights and the receipt of the Northwest stock were pursuant to a tax-free spinoff under section 355.

For these reasons, and the reasons stated at greater length in the petition for certiorari filed in the *Baan* case, supra, respondents concur in the conclusion that a petition for a writ of certiorari should be granted in this case.

Respectfully submitted,
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November 1967.

No. 781

In the Supreme Court of the United States

October Term, 1967

Oscar E. Baan and Evelyn K. Baan, petitioners

v.

Commissioner of Internal Revenue

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT

ERWIN N. GRISWOLD,
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In the Supreme Court of the United States

OCTOBER TERM, 1967

No. 781

OSCAR E. BAAN AND EVELYN K. BAAN, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT

In 1961, Pacific Telephone and Telegraph Company (Pacific) transferred part of its operating assets and cash to Pacific Northwest Bell Telephone Company (Northwest), a newly-formed corporation, in exchange for all of the stock and a $200,000,000 demand note of Northwest. Pacific announced that it would ultimately sell to its own stockholders all the Northwest stock. The number and timing of offerings, and the price to be paid for the Northwest stock, were left to the future decisions of Pacific's management.

The first offering was in 1961, when Pacific issued to its stockholders tranferable rights to purchase at $16 per share 57 percent of the Northwest stock, the market value of which was then over $26 per share.

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Pacific disposed of the remaining 43 percent in 1963 through a similar offering.

Petitioners are stockholders of Pacific who received and exercised stock rights in 1961. The issue here is the tax consequences of that transaction.

The Tax Court held that petitioners need not recognize gain on the receipt or exercise of the stock rights because the overall transaction qualified as a tax free spin-off under Section 355 of the Internal Revenue Code of 1954. On the Commissioner's appeal, the Ninth Circuit reversed the decision of the Tax Court. (Pet. App. C 52–55, 75.)

The Second Circuit considered the identical question in *Commissioner* v. *Gordon* (decided July 26, 1967, 67–2 U.S.T.C., par. 9592), pending on the Commissioner's petition for a writ of certiorari, No. 760, this Term. *Gordon* arises from the same transaction, and was tried and decided together with this case in the Tax Court. The Second Circuit, Judge Friendly dissenting, disagreed with the Ninth Circuit, and held that the transaction met the requirements of Section 355. The decision here is therefore in direct conflict with that of the Second Circuit.

In view of the conflict between the courts of appeals and its impact on the tax liability of some 2,000 Pacific shareholders (see petition for writ of certiorari in No. 760, pp. 6–7), respondent does not object to the granting of this petition.

Respectfully submitted.

ERWIN N. GRISWOLD,
Solicitor General.

NOVEMBER 1967.

U.S. GOVERNMENT PRINTING OFFICE: 1967

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In the Supreme Court of the United States

OCTOBER TERM, 1967

COMMISSIONER OF INTERNAL REVENUE, PETITIONER
v.
IRVING GORDON AND MARGARET GORDON

OSCAR E. BAAN AND EVELYN K. BAAN, PETITIONERS
v.
COMMISSIONER OF INTERNAL REVENUE

ON WRITS OF CERTIORARI TO THE UNITED STATES COURTS OF APPEALS FOR THE SECOND AND NINTH CIRCUITS

BRIEF FOR THE COMMISSIONER

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Commissioner of Internal Revenue

ON WRITS OF CERTIORARI TO THE UNITED STATES COURTS OF APPEALS FOR THE SECOND AND NINTH CIRCUITS

BRIEF FOR THE COMMISSIONER

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 227–271) are reported at 45 T.C. 71. The opinion of the Second Circuit in No. 760 (R. 275–305) is reported at 382 F. 2d 499, and that of the Ninth Circuit in No. 781 (R. 308–333) at 382 F. 2d 485.

JURISDICTION

In No. 760, the judgment of the court of appeals was entered on July 26, 1967 (R. 9, 306–307), and

the petition for a writ of certiorari was filed on October 23, 1967. In No. 781, the judgment of the court of appeals was entered on July 7, 1967, rehearing was denied on August 15, 1967 (R. 10, 334), and the petition for a writ of certiorari was filed on November 2, 1967. Both petitions were granted on January 15, 1968. (R. 335–336.) The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether a corporation's distribution to its shareholders of transferable rights to purchase at a price substantially less than fair-market value 57 percent of the stock of a wholly-owned subsidiary, where rights to purchase the remaining 43 percent were distributed twenty-one months later, qualifies for the nonrecognition of gain treatment that Section 355 of the Internal Revenue Code of 1954 allows certain distributions to shareholders of stock of a controlled subsidiary.

2. Whether the amount realized by a shareholder of the parent corporation upon the sale of such rights is ordinary dividend income or capital gain.

STATUTE INVOLVED

Section 355 of the Internal Revenue Code of 1954 appears in the Appendix, *infra*, pp. 53–56.

STATEMENT

American Telephone & Telegraph Company ("A.T. & T.") conducts its local communications business through a number of subsidiaries. In 1960, there were 20 such companies, which operated in every state except Hawaii and Alaska. (R. 230–231.)

Pacific Telephone & Telegraph Company ("Pacific") is one of A.T. & T.'s operating subsidiaries. Since 1907, A.T. & T. has owned more than 80 percent of the voting stock of Pacific. (R. 230.) Throughout 1961, it owned about 90 percent of Pacific's common stock. It also held approximately 78 percent of the preferred stock, which carried seven votes for each share. In the aggregate, A.T. & T. had 89.62 percent of the voting power. Some 38,000 persons owned the minority interests. (R. 233.) Since 1954, Pacific's federal income tax liability has been included as that of an affiliated subsidiary corporation in a consolidated tax return filed by A.T. & T. on behalf of itself and its subsidiaries (R. 233–234).

Through 1960 Pacific provided communications services in California, Oregon, Washington and Idaho, and served parts of Nevada through a wholly-owned subsidiary (R. 229, 230). In the dozen or so years following World War II, Pacific's business had increased more than five-fold, so that it became A.T. & T.'s largest subsidiary (R. 234–235). Some time in 1958 its management decided to investigate the possibilities of dividing the company into two or three separate corporations (R. 235). In addition to securing a more efficient management through decentralization (R. 236–237), Pacific had several distinct objectives and conditions that it wished to satisfy through such a division: to assure that A.T. & T. would, from the beginning, have a majority of the voting stock of the new entity (R. 90–91, 125, 164, 209–210, 281); to generate through the transaction enough cash to liquidate a substantial portion of Pacific's accumulated in-

debtedness to A.T. & T.; and to provide funds to cover Pacific's capital needs (R. 90–91, 103–104, 108–109, 191–192, 215, 226). Pacific, however, did not want to "have excess cash left over which would have to be invested temporarily at a low return". (R. 91), and wanted to minimize the tax consequences of the transaction to itself (R. 220–222). It also was interested in making the transaction attractive to Pacific's minority shareholders (R. 202, 249–251).

The ultimate result was a plan to separate the businesses Pacific conducted in Oregon, Washington, and Idaho from its operations in California and Nevada (R. 237–238). A new corporation, Pacific Northwest Bell Telephone Company ("Northwest") was formed. It issued 10,000 shares of its stock to Pacific for which it was paid $110,000 (R. 241). Pacific then transferred its assets and liabilities in those three states to Northwest in exchange for 30,450,000 shares of Northwest's common stock and a $200,000,000 demand note (R. 90–93, 242–243).

Because of Pacific's need to raise cash, and possible difficulties under state law, Pacific's management decided not to distribute the Northwest stock without payment by Pacific's shareholders (R. 239–240). Instead, Pacific decided that as soon as possible after it received the Northwest stock, Pacific would offer to sell approximately 56 percent of that stock to the holders of Pacific's common and the minority holders of Pacific's preferred. The sale of that amount would enable A.T. & T. to secure "more than 50% control" of Northwest, and yet would limit the cash proceeds to Pacific's immediate needs (R. 90–91, 239–240). The

remainder of the Northwest stock would be sold to Pacific's shareholders "by one or two subsequent offerings timed to meet [Pacific's] needs for additional capital," probably within a three-year period (R. 91).

On January 27, 1961, when the plan was proposed to Pacific's Board of Directors (R. 236), Pacific's problems in setting the sales price were explained to the Board of Directors in the following terms (Exhibit 15–0; R. 49, 91):

> The situation differs from that we have had before where the company was offering additional shares of Pacific's own stock. Here, the company will be offering to sell to its shareholders stock of a subsidiary company; in effect, it will be selling a portion of its assets. When you sell an asset the normal tendency is to sell at the highest price possible so as to protect the interests of the debenture holders, preferred shareholders and others. At the same time, the higher the price the more taxes we may have to pay on the excess of selling price over book value. A lower price would produce higher rights values and should result in a broader distribution of the stock among our shareholders. Even here, higher rights values may not be popular with some of our shareholders because they may be ruled to be taxable income, as opposed to rights to our own shares which generally receive capital gains treatment.

Consequently, the selling price was left to be determined by Pacific's board of directors "just before the date of each offering * * *" (R. 92; see, also, R. 128–132).

The plan was submitted to Pacific's shareholders

a month later (R. 74, 100). The proxy statement described the plan, and advised that "promptly" after Pacific acquired the Northwest stock, Pacific would "offer for sale about * * * 56% of such stock," through the issuance to Pacific's shareholders of rights, and that "It is expected that within about three years" Pacific "by one or more offerings will offer for sale the balance of such stock, following the procedures" of the first sale (R. 108–109). The purpose of the later sale would be "to repay advances then outstanding and for general corporate purposes * * *." (R. 109.) The price of the Northwest stock would "be determined by the Board of Directors of [Pacific] at the time of each offering." (R. 109.) Shareholders were told that "Taxable income * * * may result" to Pacific shareholders with respect to their receiving rights to purchase the shares of the new company, and stated that a ruling was being sought from the Internal Revenue Service (R. 112).[1]

Pacific's shareholders approved the plan at Pacific's annual meeting on March 24, 1961 (R. 241). All of the A.T. & T. stock (R. 111) and an overwhelming majority of the minority stock was voted in favor of the plan (R. 49–50).[2]

[1] The proxy statement stated that "[i]n the opinion of counsel" for Pacific, the exchange between Northwest and Pacific would be tax free (R. 111). No comparable statement was made regarding the tax consequences to Pacific's shareholders of their purchasing the stock of the new company.

[2] 97.19 percent of all stock voted "yes"; only 0.12 percent of the outstanding stock voted against. Some 2,977,335 shares were not voted. This accounted for 2.69 percent of the voting strength of Pacific (R. 49–50).

Pacific transferred to Northwest its assets and liabilities in Oregon, Washington and Idaho, and ceased operation of its business in those States at the close of business on June 30, 1961; Northwest commenced operations as of July 1, 1961 (R. 52–54, 243–245). On August 25, 1961, Pacific's board undertook to sell enough Northwest stock to give A.T. & T. a majority of the total shares. The Board approved the proposal of management to offer the stock for sale at $16 per share (R. 56–57, 128–132, 245–246, 248). Although the market price of the Northwest stock was expected to range between $22 and $27.50, the lower price of $16 was selected for two reasons: first, it was desired to issue Pacific's shareholders transferable rights that could be sold, if not exercised, "Since many of our shareholders consider rights values to be in the nature of additional dividends * * *" (R. 130). Second, that price would allow Pacific to pay off the outstanding advances from A.T. & T., and leave it with $34,000,000 cash, which could be used in about two months (R. 132). At the same time, this price minimized the taxes that Pacific itself would be required to pay on the amount by which the proceeds from the sale exceeded Pacific's basis in the Northwest stock (R. 131).

On September 29, 1961, Pacific issued to its common stockholders one right, evidenced by a transferable warrant, for each outstanding share of Pacific's stock (R. 245). The minority holders of Pacific preferred received seven rights for each share of preferred owned. Rights had to be exercised by October 20, 1961. Six rights and payment of $16 were required to purchase one share of Northwest stock. (R. 246.) At that time, the fair market value of the Northwest

stock was more than $26 per share (R. 139).[3] The rights covered some 57.3 percent of the Northwest stock (R. 245).

The prospectus distributed to Pacific's shareholders described the terms and conditions of the sale, and gave instructions for exercising or selling the rights (R. 117–122). The document advised that the Internal Revenue Service had ruled that shareholders who sold or exercised the rights would realize ordinary income in the amount of the sales price or the amount by which the fair market value of the Northwest stock at the time of exercise exceeded the $16 per share purchase price (R. 122–123). The shareholders were reminded that the offering was "the initial offering under the plan" to offer to sell, within about three years, the Northwest stock to the shareholders of Pacific at prices to "be determined at the time of the offering" (R. 125).

On June 12, 1963, the remaining 43 percent of Northwest stock was offered to Pacific's shareholders by a similar issuance of stock rights, on terms requiring eight rights and payment of $16 to acquire one share of Northwest Stock (R. 251–252).

Mr. and Mrs. Gordon, respondents in No. 760, and Mr. and Mrs. Baan, petitioners in No. 781 (collectively the "taxpayers"), were shareholders of Pacific who

[3] The market value of Northwest stock fluctuated between $26 and about $29.81 per share from September 14 to October 20, 1961. In the same period, the market value of each stock right ranged from approximately $1.65 to $2.23. Both the stock and the rights were traded on the American Stock Exchange (R. 247).

received rights in September 1961. On October 5, 1961, the Gordons exercised 1,536 of the 1,540 rights issued to them, acquiring 256 Northwest shares for $4,096 (R. 247). On that day, the average price of the Northwest stock on the American Stock Exchange was $26 (R. 139). On the same day, the Gordons sold their four unexercised rights for $6.36 (R. 247). On October 11, 1961, the Baans exercised all 600 rights issued to them, paying $1600 to acquire 100 shares of Northwest stock. (R. 246–247.) On that day, the average trading price of the Northwest stock was $26.94 (R. 139).

Neither the Gordons nor the Baans reported income on the receipt or exercise of the rights to acquire Northwest stock at less than fair market value (R. 68–69). Nor did the Gordons report the $6.36 received on the sale of four rights (R. 69).

The Commissioner determined that there was a deficiency owed by taxpayers for the year 1961 on the ground that, with respect to the rights which were exercised, they received a dividend measured by the difference between the fair market value of the Northwest stock on the date of exercise and the option price paid for each share of the Northwest stock (R. 26, 228, 253, 256).[4] In the Tax Court the Commissioner further alleged that the Gordons realized ordinary in-

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[4] Only the notice of deficiency issued to the Gordons is printed in the consolidated appendix (R. 23–26) as it is representative of the Commissioner's determination for all of Pacific's shareholders who received rights, including the Baans (see R. 253). The issue presented to the Tax Court as to the rights that were exercised was identical for the Gordons and Baans (R. 255–256).

come on the amounts realized upon their sale of four rights (see R. 28, 29).[5] Pacific had sufficient accumulated earnings in 1961 to cover dividends in the total amounts that the Commissioner maintained were taxable as to all Pacific shareholders who exercised or sold rights in 1961 (R. 232).

In consolidated proceedings for redetermination of deficiencies, the Tax Court sustained taxpayers' position that the basic transaction qualified for tax free treatment under Section 355 of the 1954 Code, holding taxpayers need not recognize any gain in connection with the rights they exercised. The Tax Court went on to hold, however, that gain realized by the Gordons upon the sale of rights was taxable as a dividend (R. 256–271), thus rejecting their claim that the gain was capital in character.

Two appeals were taken by the Commissioner. In the *Baan* case, the Ninth Circuit held that the transaction did not meet the requirements of Section 355, and reversed the Tax Court (R. 308–333). In the *Gordon* case, the Second Circuit sustained the Tax Court's view that no gain need be recognized as to exercised rights, but concluded that the gain realized on the sale of rights was capital in nature, and consequently reversed on the latter issue (R. 275–296). Judge Friendly dissented on both issues (R. 297–305).

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[5] It does not appear that the Commissioner originally determined a deficiency in respect of the rights the Gordons sold; nor does it appear that he had knowledge of the sale (See R. 26). In the Commissioner's answer to the Gordon's petition in the Tax Court, however, he did assert a deficiency, as stated in the text, pursuant to Section 6214(a) of the 1954 Code (R. 28, 29).

SUMMARY OF ARGUMENT

Section 355 of the Internal Revenue Code of 1954 is the latest of a series of tax provisions that over the years have alternatively denied and then granted nonrecognition or "tax-free" treatment to certain spin-off transactions. The general purpose of the statute is to avoid tax impediments to the break-up of business organizations into smaller entities. The intricate and interrelated requirements of the section are a statutory guarantee that tax-free treatment is available only when the break-up is achieved by passing control—in the sense of 80-percent stock ownership—of a subsidiary directly to the shareholders of the parent without changing their investment position. In this way the statute is a special corollary of Code provisions designed to treat as capital transactions divestments amounting to a "genuine contraction" of the original corporate enterprise. Pacific's transaction in Northwest stock served neither of these general purposes. Further, the manner in which Pacific disposed of its Northwest stock failed, in three independent ways, to qualify for the exception Section 355 grants to the general rule that a distribution of corporate property is a taxable event.

First, the statute requires the parent to "distribute * * * solely stock" of the subsidiary. Here Pacific distributed only rights, evidenced by warrants—an option to buy stock. This Court held in *Helvering* v. *Southwest Corp.*, 315 U.S. 194, that such options are not "stock." Congress has in a variety of provisions of the 1939 and 1954 Codes shown its understanding and agreeement with the view that "stock" and "rights" are separate and distinct concepts. It is, in addition,

clear from the rationale of *Palmer* v. *Commissioner,* 302 U.S. 63, 71, and *Commissioner* v. *LoBue,* 351 U.S. 243, that the distribution of rights to buy stock at less than fair-market value is a distribution of corporate property that, to a shareholder, is a dividend to the extent of accumulated corporate earnings and profits.

Second, Pacific failed in several ways to adhere to the requirement of Section 355(a)(1)(A) that it "distribute * * * to a shareholder, with respect to its stock," the Northwest stock. The Northwest stock was available to whomever had the necessary rights and cash, whether or not they were shareholders of Pacific. The requirement of cash consideration is alone enough to disqualify the transaction, since the phrase "distribution with respect to stock" is repeatedly used in the 1954 Code to refer to transfers of corporate property to persons solely because of their status as shareholders. The $16 price also meant that as a practical matter a substantial amount of the Northwest stock would not be expected to be—and in fact was not—transferred to persons who were also shareholders of Pacific.

To treat the cash consideration as a contribution to capital, as the Second Circuit did, would be inconsistent with commonly accepted notions of sales, and would be inconsistent with the established tax treatment of sales of corporate property. Moreover, the result of the cash consideration was that there was not the "genuine contraction" of the corporate enterprise that Congress evidently expected to occur in transactions qualifying under Section 355, since the

cash in large measure replaced Pacific's business in Oregon, Washington and Idaho.

Third, Pacific disposed of only 57 percent of the Northwest stock in 1961, the only taxable year in issue here, and was under no obligation to distribute any part of the remainder at any time. This state of affairs simply does not comply with the obvious intendment of the requirement of Section 355(a)(1)(D) that at least 80 percent of the subsidiary's stock be disposed of at one time. If more than one distribution is to be allowed, it then becomes impossible to administer a variety of the provisions of Section 355, which require that certain events occur or states of facts exist "immediately before", "immediately after", or "throughout the 5-year period ending on the date of" the distribution. It would in addition have been impossible, in 1961, to determine the tax consequences of Pacific's sale of the Northwest stock, even though that determination had to be made to comply with the general scheme that income taxes be measured and reported annually.

Further untoward consequences of a ruling that the split distribution here qualifies under Section 355(a)(1)(D) would be that those persons who were Pacific shareholders in September 1961 would not necessarily receive the later distributed stock, even though Section 355 contemplates a transaction whereby a parent corporation distributes control of a subsidiary to those persons who, as shareholders, represent a unity of interest in the corporation; that it would not be possible to find the genuine contraction of the business

enterprise that Congress contemplated, and it would allow a corporation to make several distributions of a subsidiary's stock at less than fair market value, with the same effect as a dividend, so long as it had some other business objective as its "principal purpose." Pacific, for example, could have done this by having the same overall financial objectives as it had in this case and selling the Northwest stock at the same $16 price in eight equal quarterly installments, beginning and ending on the dates of its actual 1961 and 1963 offerings.

A distinct issue is the proper treatment of the amounts the respondents in No. 760 realized when they sold some of their rights to buy Northwest stock. Those amounts are dividend income if the Pacific transaction fails to qualify under Section 355.

The same result should follow even if Section 355 does apply to Pacific's transaction in Northwest stock. Under the plain terms of the 1954 Code, the distribution of the rights was a distribution of Pacific's corporate property that must be taxed as a dividend, at the market value of the rights on the day they were distributed, unless an exception is found in some Code provision. But Section 355 grants nonrecognition treatment only to a "shareholder * * * on the receipt of the * * * stock" in the subsidiary. Those who sold their rights never received the Northwest stock represented by those rights, and therefore cannot qualify for the exception.

ARGUMENT

INTRODUCTION

This case turns on the construction and application of Section 355 of the Internal Revenue Code. This is a long and highly integrated provision, the full text of which is set forth in the Appendix (*infra*, pp. 53–56).

In applying the statute to this case, three specific questions of construction primarily arise:

1. Section 355(a)(1)(A) provides that the section will be applicable when "a corporation * * * distributes to a shareholder, with respect to its stock * * * solely stock or securities of a corporation * * * which it controls immediately before the distribution." The question is whether the distribution of rights by Pacific constituted a distribution of "solely stock or securities."

2. Under the rights distributed by Pacific, the recipient, or his transferee, was required to make payment of cash before he could receive Northwest stock. The question is whether the Northwest stock, so offered for purchase, comes within the statutory language, which applies only where a corporation "distributes to a shareholder, with respect to its stock." Is this a distribution, or is it a sale? If it is to be regarded as a distribution, but as a distribution of the excess in value of the Northwest stock over the purchase price required for the exercise of the rights, can such a distribution be said to be a "distribution" of the Northwest stock itself? If it is a

distribution of the Northwest stock, "with respect to" what has it been made—the stock of Pacific or the chose in action represented by six rights and $16? And to whom has it been made; can it be to "a shareholder" of Pacific even though any person could have bought the necessary rights on the stock exchange?

3. During 1961, the tax year here in question, Pacific sold only 57 percent of the Northwest stock. Section 355(a)(1)(D) of the Internal Revenue Code provides that the section is applicable where "as part of the distribution, the distributing corporation distributes" stock amounting to control, which, under the terms of Section 368(c) of the Code requires 80 percent of the stock of Northwest. The question is whether a disposition of 57 percent of the stock in 1961 can be regarded as coming within the proper construction of this provision, where the remaining 43 percent was disposed of 21 months later in a transaction which was in no way obligated at the time the first offering was made. Can an offering of 57 percent of stock, with no further obligation, constitute disposition of "control" when that term is specifically defined as requiring "at least 80 percent" of the voting stock?

In considering the construction of Section 355, it may be helpful to put the statute in its setting. The general type of transaction involved here has been called a "spin-off," although we do not think that the actual transactions here were a spin-off, since (1) it involved a sale of stock, rather than a distribution, and since (2) only 57 percent of the stock of North-

west was disposed of, the balance being retained by the parent company for a further 21 months.[6]

The first provision in the tax laws allowing tax-free treatment of spin-offs was enacted in 1924. Section 203(c) of the Revenue Act of 1924, c. 234, 43 Stat. 253, 256–257, provided that no gain or loss would be recognized if a corporation distributed shares after transferring some or all of its property to a second corporation, and the first corporation or its shareholders had at least 80 percent of the shares of the second corporation. It became apparent, however, that Section 203(c) could lead to widespread tax avoidance.[7] Congress in 1934, therefore, repealed the provision. See Revenue Act of 1934, c. 277, 48 Stat. 680.

For the next 17 years, a spin-off was treated as a dividend to the extent that the fair market value of the stock received by shareholders reflected earnings and profits of the distributing corporation. It mat-

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[6] Congress in 1951 said, "A spin-off occurs when a part of the assets of a corporation is transferred to a new corporation and the stock in the latter is distributed to the shareholders of the original corporation * * *." S. Rep. No. 781, 82d Cong., 1st Sess., at p. 57.

[7] For example, cash or other liquid assets could be transferred to a new corporation, and its shares distributed to the shareholders of the transferring corporation. Then, under the literal terms of the statute, the new corporation could be liquidated at capital gains tax rates. See *Parshelsky's Estate* v. *Commissioner*, 303 F. 2d 14, 17–18, 20 (C.A. 2); *Commissioner* v. *Wilson*, 353 F. 2d 184, 186 (C.A. 9). Taxpayers attempted to proceed in just this manner. This Court ruled in *Gregory* v. *Helvering*, 293 U.S. 465, after the repeal of the 1924 Act, that such a transaction should be treated as a dividend even for years when the 1924 Act was in force.

tered not that a particular spin-off may have served a legitimate business need or was untainted by tax-avoidance objectives.

In 1951, Congress added Section 112(b)(11), 65 Stat. 452, 493, to the Internal Revenue Code of 1939 to provide nonrecognition treatment to some spin-offs. This time the statute was more carefully safeguarded. Like the 1924 Act, the 1951 amendment allowed tax-free treatment of spin-offs that were accomplished by transferring assets to a second corporation while the first corporation or its shareholders remained in 80-percent control. There was added, however, the proviso that both corporations must "intend * * * to continue the active conduct of a trade or business after such reorganization," and that the new corporation must not be "used principally as a device for the distribution of earnings and profits to the shareholders of any corporation a party to the reorganization." The Senate Finance Committee, in recommending the legislation, commented, "[I]t is economically unsound to impede spin-offs which break-up businesses into a greater number of enterprises, when undertaken for legitimate business purposes." S. Rep. No. 781, 82d Cong., 1st Sess., p. 58.

When Congress drafted the Internal Revenue Code of 1954, it undertook to treat the general subject of distributions by corporations to their shareholders in a comprehensive manner that would add certainty to this area of law. It drafted Section 355 to deal with

spin-offs and certain similar transactions.[8] The new statute carried forward the requirements of the 1951 Act, but added several specific and detailed new requirements, thus narrowing substantially the class of transactions that would qualify for nonrecognition. This is the provision which is invoked in this case.

The question on which this case turns is a somewhat intricate and technical one. In the pages which follow we have tried to pursue the technical argument as carefully and thoroughly as possible. It may be appropriate here, therefore, to seek to put the case in its somewhat larger setting.

Congress has, in Section 355 made special provision for corporate "spin-offs." This was done after some thirty years of history, and we know of no reason why the statute should be given a narrow or niggardly construction insofar as it is sought to use it to carry out the objective which Congress had in mind in enacting it. But neither is an unduly expansive reading, one that ignores the "ordinary, everyday senses" of the words, *e.g., Crane* v. *Commissioner,* 331 U.S. 1, 6, needed to attain the legislative objective.

That objective was to facilitate the breaking down of the size of corporate undertakings, as is clearly

[8] Section 355 also applies to "split-offs" and "split-ups", which are similar to spin-offs, in the sense that the stock of a corporate subsidiary is distributed to the parent's stockholders. The difference is that in a split-off the stockholders must surrender part of their stock in the parent, and in a split-up those shareholders receiving stock in the subsidiary surrender all of their stock in the parent. See S. Rep. No. 1622, 83d Cong., 2d Sess., pp. 266–267; Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders* (2d ed.), pp. 450–451.

indicated by the extract from the 1951 Committee Report which is quoted above (p.18, *supra*). The spin-off which Congress had in mind, and to which the language of the statute is clearly directed, is the breaking up of a business into two or more separate entities, with the consequence that the size of the original corporate enterprise is contracted by the genuine separation of its businesses into distinct entities. The shareholders continue to own both, having now more pieces of paper to represent their aggregate ownership than they had before.

Although there was here clearly a "business purpose," so that such cases as *Gregory* v. *Helvering*, 293 U.S. 465, are not directly applicable, there are at least two reasons why the transaction falls outside the basic objective of the "spin-off" statute:

1. It was not a breaking up of a large business venture into two or more separate organizations. On the contrary, it was simply the rearrangement of the existing activity, all within the same corporate control. There was no separation off; there was, indeed, no real "spin-off." Nor can there be any break-up of a business in a spin-off of a subsidiary of a subsidiary to the ultimate parent. Congress thus must have had in mind a spin-off to persons other than a parent of a parent. Perhaps if Congress had foreseen the latter uses of the spin-off, it would have denied tax-free treatment to the extent that a consolidated return is unavailable or minority shareholders are involved. Congress did not do so, and we would not attack Pacific's transfer of the Northwest shares to A.T. & T. and the minority rights holders if the transaction

complied with the several conditions of Section 355. But where, as here, Pacific, in order to obtain its own unique business purposes, chose not to follow several of the statutory commands, a judicial relaxation of the statute would in no manner achieve Congress's underlying objectives.

2. It was not an outright distribution of shares to shareholders. Even ignoring A.T. & T. as the common parent, there was no genuine contraction of the Pacific business enterprise. On the contrary, the disposition of the Northwest shares was a part of an elaborate refinancing operation, through which, in effect, Pacific sold, at a small discount, its Washington, Oregon and Idaho assets to its shareholders, and used the proceeds to pay back money which it had borrowed to finance its expansion over the prior year or two, and to provide itself with capital for further expansion. These were wholly legitimate objectives, but they were not the sort of transaction which Congress had in mind when it provided that no income would be recognized when a corporation "distributes" to its shareholders stock which constitutes "control" of a subsidiary corporation.

Here, though in a quite different way, Pacific and its shareholders seek to "use" the statute quite as much as its predecessor was used by Mrs. Gregory, the taxpayer in *Gregory* v. *Helvering, supra.* Indeed, Pacific found the way that would provide no tax for its parent A.T. & T., and very little tax for itself. It did not obtain a ruling from the Treasury that its outside shareholders would not be taxable, and so advised

these shareholders. Nevertheless, it, and they, went ahead.

Where a taxpayer is trying to carry out an objective established by Congress, the statute may well be given a broad, and, indeed, a generous construction. Where the taxpayer's objective, however, is to obtain a result quite different from that which Congress had in mind in enacting the statute, there is no reason why the statute should not be read as it is written, and construed to exclude the taxpayer who does not come within its highly articulated terms. This is the policy approach which we would suggest in this case, and which may well serve as background for the technical argument which follows. In the *Gregory* case, the taxpayer brought herself within the literal language of the statute, but the Court held that the statute should not be construed to apply to her case since the transaction she carried out did not come within the objectives intended by Congress. It was verbally, but not truly, a "reorganization"; it was not the sort of "reorganization" that Congress contemplated when it wrote the statute. Here the transaction is not literally within the ambit of the statute, for reasons which we develop further below. But, in addition, it is not within the purpose or objective of the statute, since the transaction here was not a true "spin-off," not the sort of distribution that Congress had in mind when it enacted the statute. In some cases, it may be wise and appropriate to give statutory language a broad construction, in order to facilitate carrying out its intended purpose. Where, as here, though, the practical result sought to be reached is not within the gen-

eral scope or objective of the statute, there is no reason for going beyond the terms of the statute as Congress has written them.

We now turn to a specific examination of the application of the statute to the facts of this case. Our argument is presented in terms of the three problems of statutory construction presented at the beginning of this Introduction (pages 15-16, *supra*).

I. PACIFIC DID NOT DISTRIBUTE "SOLELY STOCK OR SECURITIES" OF NORTHWEST

Section 355(a)(1)(A) provides that if there is to be nonrecognition of gain, the parent corporation—here Pacific—must "distribute to a shareholder, with respect to its stock * * * solely stock or securities of" a controlled subsidiary—here Northwest. In fact, Pacific distributed only rights evidenced by transferable warrants. These rights or warrants are not stock, but simply a privilege to buy stock—an option to purchase Northwest stock at a fixed price binding on the seller but not on the buyer.[9]

It has been clear ever since the decision in *Helvering* v. *Southwest Corp.*, 315 U.S. 194, 200-201, that stock warrants are not "stock." There, in considering the meaning of the phrase "voting stock" in

[9] There is no claim that "securities" were distributed. If the rights were "securities," nonrecognition treatment would be unavailable by reason of the provisions of Section 355(a)(3)(B), which denies such treatment to the distribution of securities if, as here, no "securities" were "surrendered."

Section 112(g), the reorganization provisions, of the Revenue Act of 1934, the Court said:

> [A] warrant holder * * * is not a shareholder. * * * His rights are wholly contractual. As stated by Holmes, J., in *Parkinson* v. *West End Street Ry Co.,* 173 Mass. 446, 448, 53 N.E. 891, 892, he "does not become a stockholder by his contract in equity any more than at law." At times, his right may expire on the consolidation of the obligor corporation with another. *Id.* If, at the time he exercises his right, there are no authorized and unissued shares to satisfy his demand, he will get damages, not specific performance. * * * Thus, he does not have, and may never acquire, any legal or equitable rights in shares of stock. * * * And he cannot assert the rights of a shareholder. * * * [Citations omitted.]

Congress has shown its awareness of and its agreement with this rule in adopting special legislation, Section 373 of the 1939 Code, now Sections 1081-1083 of the 1954 Code, to permit tax-free distributions of stock and securities in a divestiture ordered by the Securities and Exchange Commission. There, Congress specifically defined "stock and securities" for such purposes to include stock rights and stock warrants, recognizing that it was giving the phrase a broader meaning than it ordinarily had (S. Rept. No. 1567, 75th Cong., 3d Sess., pp. 36-37):

> In order to facilitate exchanges or distributions in furtherance of the policies of section 11(b) of the Public Utility Holding Company Act of 1935, the term "stock or securities" is given a broader meaning in section 373(f) than

> it possesses in connection with the reorganization provisions of section 112 [1939 Code]. It is defined to mean stock or other certificates of interest in a corporation on the one hand, and notes, bonds, debentures, and other evidences of indebtedness, whether of a corporation or an individual, on the other. Since voting trust certificates, stock rights or warrants, etc., are merely evidences of the ownership or the right to acquire more direct interests, such instruments are also included.

The same point appears from several sections of the 1954 Code. In Section 305(a) Congress codified the rule that this Court established in *Eisner* v. *Macomber*, 252 U.S. 189, that a distribution of a corporation's own stock is not "income." The statutory language is:

> Except as provided in * * * [Section 305(b)], gross income does not include the amount of any distribution made by a corporation to its shareholders, with respect to the stock of such corporation, *in its stock or in rights to acquire its stock.* [Emphasis supplied.]

A parallel clause in Section 317(a)—which defines generally the word "property"—provides that "'property' * * * does not include stock in the corporation making the distribution (or rights to acquire such stock)." Section 311(a)(1), in defining the effect of various corporate distributions on the corporation, in similar manner speaks of the corporation's "stock" and "rights to acquire its stock" as separate categories. Surely, then, Congress viewed "rights to acquire stock" as something other than "stock."

The Second Circuit majority did not rule that stock

"rights" are the equivalent of "stock or securities." Rather, relying on *Palmer* v. *Commissioner*, 302 U.S. 63, and *Choate* v. *Commissioner*, 129 F. 2d 684 (C.A. 2), it held that (R. 286):

> * * * the distribution of a stock right has no tax consequences because there is no distribution of corporate property until the right is exercised. * * * [I]t is the actual distribution of the Northwest stock upon the exercise of the rights that is the relevant event and the use of the stock rights as a mere mechanism to accomplish this result should be disregarded.

Of course, were the Second Circuit correct in asserting that the issuance of rights is merely "a mechanism" for the distribution of stock, this Court would have reached a quite different result in *Helvering* v. *Southwest Corp., supra.* See the Ninth Circuit's opinion in *Baan,* at R. 319–320.

Palmer and *Choate* do not, in any event, hold that the issuance of rights to acquire the stock of another corporation and their subsequent exercise may be telescoped into a single event. As Judge Frank's analysis of *Palmer* and *Choate* makes clear, 129 F. 2d at 686–687, those cases decide—under the pre-1954 statutes—only the date to be used in determining whether the issuance of rights results in income to the stockholders receiving them—the date when the rights are issued or the later date when they are exercised. The Court's observation in *Palmer* (302 U.S. at 71) that the "mere issue of rights to subscribe and their receipt by shareholders, is not a dividend" must be read in light of the fact that in *Palmer* there was no spread between the option price

and the fair-market value of the offered stock at the time the rights were issued, although the market value was above the option price on the day of exercise.

Any relevance of *Palmer* in this case is in the comments this Court directed at the situation—such as the one here—where the price of corporate property to shareholders is lower than the market value on the day of issuance (302 U.S. at 69):

> On the other hand, such a sale, if for substantially less than the value of the property sold, may be as effective a means of distributing profits among stockholders as the formal declaration of a dividend. * * * and such a transaction may appropriately be deemed in effect the declaration of a dividend, taxable to the extent that the value of the distributed property exceeds the stipulated price. * * *

This Court, moreover, made clear in *Commissioner* v. *LoBue,* 351 U.S. 243, that a *transferable* right having a readily ascertainable value—such as are involved in this case—is assuredly "property" the distribution of which may in itself be ordinary income. There the question was whether an employee who received a non-transferable option to acquire, at less than fair-market value, stock of his employer corporation should be taxed at the time the option was exercised rather than at the time it was issued. The decision that the tax was to be measured by the difference between the option price and the value at the time of exercise rested on the fact that the option had no readily ascertainable market value when issued because it was then contingent and not transferable. The Court noted, however (351 U.S. at 249):

> It is of course possible for the recipient of a stock option to realize an immediate taxable gain. See *Commissioner* v. *Smith*, 324 U.S. 177, 181–182. The option might have a readily ascertainable market value and the recipient might be free to sell his option. But this is not such a case. * * *

The present litigation is, in contrast, "such a case." The rights Pacific issued in Northwest stock had value; they were traded on the stock exchange on a "when issued" basis as early as September 14, 1961, six days before the rights were distributed to Pacific's shareholders. (R. 140.) And Pacific's management, in formulating its 1961 transaction in Northwest stock, expressly "contemplate[d] reasonable rights values." (R. 130.)

The 1954 Code itself further supports the conclusion that a distribution of transferrable rights to acquire corporate property at less than fair market value is taxable. Section 317(a) defines "property", for purposes of the provisions dealing with taxable corporate distributions, as "money, securities, and any other property"; it excepts solely "stock in the corporation making the distribution (or rights to acquire such stock)" in order to conform to the codification of the rule of *Eisner* v. *Macomber, supra,* in Section 305(a). Section 317's broad definition of property plainly includes stock of a second corporation and rights to acquire that stock. Pacific's distribution of transferrable rights to acquire the Northwest stock was necessarily a distribution of property and not an event that may be ignored as a mere

"mechanism." See, generally, Carlson, *Taxation of "Taxable" Stock Rights: The Strange Persistence of Palmer* v. *Commissioner,* 23 Tax L. Rev. 129; Whiteside, *Income Tax Consequences of Distributions of Stock Rights to Shareholders,* 66 Yale L. J. 1016. But it was not a distribution of "stock" in Northwest. The Pacific shareholder could receive Northwest stock only by making a substantial payment to Pacific. When Pacific thereupon transferred Northwest stock to its shareholder, it was a sale, not a distribution. The Pacific shareholder did not receive "solely stock or securities" from Pacific, as Section 355(a)(1)(A) requires.

II. PACIFIC DID NOT "DISTRIBUTE TO A SHAREHOLDER WITH RESPECT TO ITS STOCK" THE NORTHWEST STOCK

A. THE INTERNAL REVENUE CODE CONSISTENTLY USES THE PHRASE "DISTRIBUTE WITH RESPECT TO STOCK" TO REFER ONLY TO DISTRIBUTIONS TO SHAREHOLDERS WITHOUT CONSIDERATION

When the stock rights issued to Pacific's shareholders were exercised, Pacific did not "distribute to a shareholder with respect to its stock" the Northwest stock, as required by Section 355. Rather, it sold the Northwest stock to whomever had six rights and $16. The rights themselves were transferable and, a purchaser of the Northwest stock through exercise of the rights may or may not have been a Pacific shareholder. If a purchaser was a Pacific shareholder, he may have received his rights "with respect to" his stock in Pacific; he might, however, have bought some of his rights on the stock exchange from some other shareholders who, like respondents in No. 760, sold

rights. Persons who were not Pacific shareholders could also have bought the rights. Anyone who did buy rights received Northwest stock only "with respect to" rights plus $16, and not "with respect to" stock of Pacific.

The phrase "distribution * * * with respect to * * * stock" is a term of art with a consistent meaning throughout the Internal Revenue Code. It is always used to refer to distributions without consideration, and never refers to sales. Section 305 thus makes tax-free a "distribution * * * with respect to the stock of such corporation" of "its stock or * * * rights to acquire its stock." Section 301 uses the phrase in establishing the basic rule that a dividend is taxable as ordinary income. Section 307 uses it in describing the basis of distributed property in the hands of the recipient shareholder, and Section 312 does so in determining the effect of a distribution of corporate property on the company's earnings and profits. All of these sections deal with circumstances where someone receives some corporate asset solely because of his status as a shareholder, and without providing or paying any consideration.

Section 311(a) may demonstrate most clearly of all that the phrase "distribute * * * with respect to its stock" precludes a transaction in which the corporation receives consideration from its shareholders. Section 311(a)(2) states as a general rule that a corporation shall not recognize any gain or loss in a "distribution, with respect to its stock * * * of property." Such treatment is, however, plainly inconsistent with the view that a "distribution with

respect to its stock" could include a sale, for on a sale the corporation must recognize gain to the extent that the purchase price exceeds the adjusted basis of the property. See Sections 1001 and 1002 of the 1954 Code. In addition an exception to the general rule, established in Section 311(c), provides that upon a corporate "distribution with respect to its stock of * * * property" subject to a liability in excess of the corporation's adjusted basis in the property, "gain shall be recognized to the distributing corporation in an amount equal to such excess as if the property distributed had been sold at the time of distribution." This is a specific application of the general rule that an assumption of liability is treated as a payment of money. *E.g., Crane* v. *Commissioner,* 331 U.S. 1, 12–14. This exception would have been unnecessary if the phrase, "distribution with respect to its stock", includes a sale. If the words do comprehend a sale, Congress would hardly have used in Section 311(c) the phrase, "as if the property distributed had been sold at the time of the distribution."

B. VIEWING THE $16 CASH CONSIDERATION AS A CONTRIBUTION TO THE CAPITAL OF PACIFIC WOULD BE INCONSISTENT WITH COMMONLY ACCEPTED IDEAS OF WHAT CONSTITUTES A SALE AND ITS TAX CONSEQUENCES

In rejecting the Commissioner's contention that a "distribution with respect to * * * stock" cannot describe a transaction requiring the shareholder to pay a cash consideration, the Second Circuit acknowledged (R. 286–287):

> It is perfectly obvious that the Code does not contemplate the receipt of cash by a corporation

> in connection with a distribution with respect to its stock in the sense that some specific section of the Code spells out the tax result. See Sections 311(a) and 312(d). But it scarcely follows that the Code prohibits the receipt of cash * * *.

Having thus disposed of the statutory pattern of using the phrase "distribution with respect to * * * stock" only in circumstances where a sale is not intended, the Second Circuit majority viewed the transfer of Northwest stock from Pacific to holders of the stock rights as an event separate from the payment of the $16 consideration by the holders of those rights. It adopted the reasoning of the Tax Court that (45 T.C. 71, 90; R. 285):

> [i]f Congress had intended that a distribution of the Northwest stock be treated as tax free when made without consideration, it is inconceivable that it could have intended the transaction to result in taxable income to the distributees where they *paid out* money in connection with receiving such stock. * * * [Emphasis in original.]

The Second Circuit suggested (R. 287) that the payment of the $16 "can be treated very simply as a contribution to capital by a shareholder."

This analysis, to begin with, ignores the reality of what happened. There is nothing in this record to show that any of Pacific's shareholders would have invested cash in Pacific apart from the *quid pro quo* of Northwest stock. This is especially true of those who bought Northwest stock after buying rights on the stock exchange. This latter group was considerable.

(See p. 35 *infra.*) Thus, the transaction must be taken as it stands—an exchange of property for cash. And, as such, it must be denominated as would any such transaction—by the word that Pacific itself used to describe what it was doing, a "sale" (R. 117, 118).

The characterization of the cash payment as "a contribution to capital" creates problems that the Second Circuit recognized, but ignored as "not before us" (R. 287 and n. 5), relating to the proper treatment of the transaction from Pacific's standpoint. Pacific, in treating the transaction as a sale of property, reported gain measured by the excess of the amount of money it received for Northwest stock and the lesser basis that the Northwest stock had in Pacific's hands.[10] Under Section 118 of the Code, however, a "contribution to capital" is expressly excluded from the corporation's gross income. Therefore, under the Second Circuit's analysis Pacific should be entitled to a refund of the taxes it paid, on the ground that the transaction was not a sale, but was simply two separate transactions, a distribution of property and a contribution to capital. If this is so here, it presumably would also be true in any other case where a corporation sells its property at a profit to its shareholders. Any such transaction can be separated into two parts, as the Second Circuit did here; a distribution of property, and a

[10] The use of consolidated returns eliminated that portion of the gain represented by A.T. & T.'s exercise of the rights issued to it. There still remained some $8,700,000 of taxable gain on the sales of Northwest stock to others than A.T. & T. (R. 248) and an additional amount was presumably reported as a result of the sale of the remaining 43 percent of the Northwest stock in 1963.

contribution to capital.[11] There is no precedent for such an analysis in any of the reported cases. Plainly such a departure from the commonly accepted idea of "sale" should not be adopted "absent congressional guidance in this direction." *Commissioner* v. *Brown*, 380 U.S. 563, 575.

C. THE REQUIREMENT OF CONSIDERATION IS INCONSISTENT WITH THE STATUTORY PROVISION THAT THE DISTRIBUTION BE TO THE PARENT'S SHAREHOLDERS

The requirement of Section 355(a)(1)(A) that the "distribution" be to the corporation's "shareholder[s]" reflects the general rationale underlying the reorganization provisions of the Code—that merely a change in corporate form has occurred when the shares of the two corporations resulting from the separation of one are owned by the same persons who were the shareholders of the original enterprise. The very issuance of transferable rights means that the

[11] An added difficulty with the Second Circuit's analysis lies in the computation of the basis of the Pacific and Northwest stock. If the $16 is a contribution to Pacific's capital, it should be added to the contributor's basis in Pacific stock, see Section 1012 and Section 1016(a)(1) of the 1954 Code; Treas. Reg. Secs. 1.118-1, 1.263(a)-2(f); even though it is plainly part of the cost of the Northwest stock. Then, what would be the result to those who owned no Pacific stock, but purchased rights to the Northwest stock? And how would all this be squared with the requirements of Sections 358(a), (b) and (c) that in a transaction that comes within the terms of Section 355, the shareholder's basis in the parent's stock be allocated in part to the subsidiary's stock that the shareholder receives?

people receiving the Northwest stock will not necessarily be the same ones who, as shareholders of Pacific, received the rights to buy the Northwest stock. Pacific intentionally made it easy for the rights to be sold, explaining in its prospectus how such sales were to be made (R. 120–121). The requirement of a $16 payment made sales particularly likely. As the Ninth Circuit reasoned (R. 326), "it could well be that a substantial number of the distributing corporation's shareholders would, under the circumstances of a particular case, choose to sell their stock rights rather than to themselves make the cash payment which exercise of the stock rights would entail."

That in fact happened. Individuals, trustees and nominees bought 975,884 shares, only some five-eighths of the amount for which they received rights (R. 141), indicating they had sold rights to about 570,000 shares.[12] Brokers as a class, in contrast, used the rights to purchase 613,789 shares of Northwest—more than quadruple the number of shares for which brokers, as shareholders of Pacific, received rights thus indicating that they or their clients had bought rights to about 470,000 shares.

D. THE REQUIREMENT OF CONSIDERATION IS INCONSISTENT WITH CONGRESSIONAL INTENTION THAT A TAX-FREE SPIN-OFF RESULT IN A GENUINE CONTRACTION OF THE ORIGINAL CORPORATE ENTERPRISE

The very nature of a cash payment, moreover, took Pacific's transaction outside the intended ambit of Section 355, because there then could not be a real contraction of the Pacific enterprise. The justification

[12] 80,759 rights representing some 13,400 shares were allowed to lapse (R. 141).

for providing nonrecognition treatment to spin-offs coming within the terms of Section 355 lies in the fact that such transactions would be partial liquidations taxable at capital-gains rates under Section 331(a)(2) and 346(a)(2) and (b) of the 1954 Code, but for the facts that stock rather than other property is "distributed" and that no stock of the distributing corporation is redeemed. In the partial-liquidation provisions, Congress has sought to tax as capital gains, rather than ordinary income, corporate distributions that amount to "a genuine contraction of the business" of the company. S. Rep. No. 1622, 83d Cong., 2d Sess., p. 262; see, also, Treas. Reg. Section 1.346-1(a). The partial liquidation provisions deal with the situation where the assets representing the terminated business are distributed directly to the shareholders, an event that requires immediate recognition of gain. In a Section 355 transaction, however, nonrecognition is granted because the business that one corporation terminates continues in another corporate form, and is still owned by the same shareholders. But the similarity of the statutory language[13] shows that in each

[13] In Section 346(b)—the so-called "safe-harbor" provision—Congress established a specific example of a distribution that was an adequate "contraction" to qualify for taxation at capital-gains rates: when "the distribution is attributable to the corporation's ceasing to conduct, or consists of the assets of a trade or business which has been actively conducted throughout the 5-year period immediately before the distribution"; and (Section 346(b)(2)) "[i]mmediately after the distribution the liquidating corporation is actively engaged in the conduct of a trade or business, which trade or business was actively conducted throughout the 5-year period ending on the date of the distribution." Compare the very similar language used in describing

case Congress contemplated the same "genuine contraction" of the original enterprise.

The cash payment here meant that although part of the corporate property was removed from the Pacific enterprise, cash was in a very substantial degree substituted for it. This is not "a genuine contraction" of the business enterprise such as Congress had in mind. Compare Rev. Rul. 67–299, 1967–37 Int. Rev. Bull. 8. Nor is it the sort of "break-up", see p. 18, *supra,* which the 1951 Congress was seeking to encourage when, for the first time since 1934, it allowed tax-free treatment to some spin-offs. If Pacific had sold its assets in Washington, Oregon and Idaho to its shareholders at less than fair-market value, the result would have been a dividend and not a partial liquidation entitled to capital-gains treatment. Treas. Reg. § 1.301–1(j); see *Gibson* v. *Commissioner,* 133 F. 2d 308 (C.A. 2). Statutory language much clearer than that used here should be necessary to give the transaction not only capital status, but the greater benefit of nonrecognition simply because stock representing the assets was sold.

Pacific, as far as this record shows (see R. 240), could have planned its disposition of the Northwest stock so as to "distribute * * * to a shareholder, with respect to its stock" the Northwest stock. For example, it could have distributed the Northwest stock

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the "active business" requirements a spin-off must satisfy to qualify for nonrecognition treatment. Sections 355(b)(1)(A) and 355(b)(a)(8). See H. Rep. No. 2543, 83d Cong., 2d Sess., p. 38.

directly to the Pacific shareholders without consideration. It consciously chose to do otherwise, for its own reasons, knowing full well that the government would resist any claim of nonrecognition treatment by Pacific's minority shareholders.[14] Federal taxes were a neutral factor, since Pacific's membership in the A.T. & T. complex meant that any tax impact on its major shareholder would disappear on the consolidated return.[15]

It did not suit Pacific's purposes to distribute the stock to its own shareholders without consideration, for it wanted to use the stock as a means of raising the funds to pay off the advances from A.T. & T. and to raise additional capital for use in its California operations. Pacific could also have sold the Northwest stock at market value, a course it recognized as "the normal tendency" (R. 91), in which case its shareholders would have received no gain in the transaction. The record shows, however, that Pacific consciously chose a lower price "[s]ince many of our shareholders consider rights values to be in the nature of additional dividends" (R. 130); and the lower the sales price, the higher would be the rights value.[16]

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[14] Not only did the Internal Revenue Service rule that the transaction would fail to qualify for nonrecognition, but Pacific's own legal counsel was apparently unwilling, even before receipt of that ruling, to advise to the contrary. See footnote 1, p. 6, *supra*.

[15] But for the consolidated return, A.T. & T. would have realized about $150,000,000 gain if the transaction failed to qualify under Section 355, since it purchased more than 15,000,000 Northwest shares in 1961 (R. 125).

[16] The offering price, moreover, came within one or two percent of the exact figure needed to make the amount paid by

Although a higher offering price would have given Pacific more money, each additional dollar charged for the Northwest stock would have resulted in 30 to 50 cents of taxes (R. 137), a discount Pacific itself was unwilling to pay for the additional capital (R. 131).

The Second Circuit majority, in ruling for the taxpayers, apparently did not conclude that Pacific squarely satisfied all the requirements of Section 355 (a)(1)(A); it did not dispute Judge Friendly's dissenting suggestion, "Certainly the words have an uneasy fit to the transaction here in question." (R. 303.) Rather, it thought it should use "a certain flexibility in applying the Code" and avoid "undermining the general purposes of the Code through an overly literal application of each of its technical provisions * * *." Therefore, it based its ruling in large part on the view that Pacific's transaction "fulfilled a valid business purpose," and did not present "any opportunity for the taxpayers to use this transaction for a bailout of earnings and profits." (R. 282, 284-285.)

Here the very intricate changes of the statute in 1954, in terms so markedly different from those adopted in 1951, coupled with the prior history of spin-off transactions makes very plain that there was no congressional desire "to have the Commissioner or the courts make a determination in each case as to whether the use * * * was for tax avoidance." *Braunstein* v. *Commissioner,* 374 U.S. 65, 71; cf. *Hanover*

A.T. & T. for the 15,548,140 shares for which it received rights (R. 125) equivalent to the indebtedness of about $245,000,000 Pacific then owed to A.T. & T. (R. 132, 136).

Bank v. *Commissioner,* 369 U.S. 672, 687; *Crane* v. *Commissioner,* 331 U.S. 1, 6. Pacific avoided the requirements of Section 355 that were inconsistent with its own peculiar financial objectives. When it did so, it created a transaction other than the "distribution * * * with respect to its stock * * * solely of stock or securities" that Congress had in mind. As a result, the transaction was one to which nonrecognition of gain should not apply.

III. TWO SEPARATE DISTRIBUTIONS, OF 57 AND 43 PERCENT OF THE STOCK MADE OVER A PERIOD OF 21 MONTHS DO NOT SATISFY THE REQUIREMENT OF SECTION 355(A)(1)(D) THAT THE PARENT DISTRIBUTE AT LEAST 80 PERCENT OF THE VOTING STOCK OF THE SUBSIDIARY

Section 335(a)(1)(D) requires that "as part of the distribution" the distributing corporation—in this case Pacific—have and then part with at least 80 percent of the voting stock of the subsidiary—here Northwest. Although Pacific started with all of the Northwest stock, in 1961—the only taxable year involved in this litigation—it parted with 57 percent. At that time Pacific "expected that within about three years * * * the Company by one or more offerings will offer for sale the balance of" the Northwest stock (R. 109). As the Second Circuit majority said, "It was left to the sole discretion of the Pacific management, however, to determine the number of offerings of Northwest stock to the Pacific shareholders and the price at which the stock would be made available" (R. 281; see, also, the Ninth Circuit opinion at R. 329–330; see R. 108–109.)

Pacific thus was under no obligation to offer the re-

mainder of the Northwest stock at any point in time. When it did seek to dispose of the remaining Northwest stock, the transaction was as distinct as it was widely-spaced from the 1961 offering.

The language of Section 355(a)(1)(D) contemplates one and not two unconnected distributions of stock. This is apparent from the wording of the Section as a whole. Thus, there are frequent references to things being done "immediately before" or "immediately after" "the distribution". This indicates that Congress contemplated a single "distribution", which would provide a specific date from which certain events may be measured or tests applied. Section 355 (a)(1)(D)(i), for example, requires that "all of the stock and securities in the controlled corporation held by [the distributing corporation] * * * immediately before the distribution" be distributed. Section 355(a)(1)(A) requires that the distributing corporation control the subsidiary "immediately before the distribution"; Section 355(b)(1) requires that active businesses be conducted "immediately after the distribution"; Section 355(b)(2)(A), in defining what is meant by "active conduct of a trade or business", again uses the phrase "immediately after the distribution"; the latter section also requires that the trade or business have been "actively conducted throughout the 5-year period ending on the date of the distribution." This requirement is also incorporated into subsections 355(b)(2) (C) and (D).

Thus Congress must have intended that "the distribution" occur in such a way that what occurred "immediately before", "immediate after", and

during the 5-year period "ending on the date of the distribution" can be determined.

These dates can not be fixed when a distribution is spread over an originally indefinite period of time as in this case. Unless the phrase "the distribution" in Section 355(a)(1)(D) be given its plain meaning—that the stock be disposed of in a single transaction—the Commissioner and the courts will be unable to apply with certainty these many requirements.

The contrary result reached by the Second Circuit cannot be squared with the general concept found in every Revenue Act since 1913, that the income tax is to be "uniformly assessed * * * on the basis of annual returns showing the net result of all the taxpayer's transactions during a fixed accounting period * * *." *Burnet* v. *Sanford & Brooks Co.*, 282 U.S. 359, 363. Neither the Commissioner nor the taxpayers here could have determined what the correct tax liability was on this transaction when 1961 had come to a close. They could not know then whether Pacific would ultimately distribute the rest of the Northwest stock or when that final event would occur. Only by waiting until mid-1963 could the tax consequences of the 1961 distribution be determined, if the Second Circuit's result is accepted.

When Congress intended that the tax consequences of a transaction be determined by examining events occurring in more than one taxable year, it has said so explicitly, and has made provision for appropriate adjustments. See Sections 172(b), 381, 382, 1301, 1302, 1303, and 1311. Cf. Section 2055(b)(2). No similar provisions may be found in Section 355.

There is no basis for the Second Circuit's con-

clusion that "neither of the purposes suggested by subsection (a)(1)(D) will be defeated by permitting more than one distribution * * *." The first purpose is that the contraction of the original corporate enterprise be by a spin-off of a distinct "trade or business." See p. 36 and n. 13 *supra*. The requirement that at least 80 percent be distributed "is designed to differentiate between genuine separations and incidental distributions of a controlled corporation's stock which would take the place of current cash dividends." Surrey & Warren, *Federal Income Taxation*, p. 1640 (1960). Plainly there is no event that may be called such a separation if more than one distribution is allowed.

Furthermore, the requirement of section 355(a)(1)(A) that the distributing corporation control the subsidiary "immediately before" the distribution establishes that the distributing corporation will surrender a distinct "trade or business." See Section 355(b)(2)(A). Yet, if the present transaction is allowed to qualify, then Pacific could not have "controlled" Northwest "immediately before" the 1963 distribution of 43 percent of Northwest's stock.

The other principal purpose of Section 355(a)(1)(D) was "to prevent a parent corporation from making periodic distributions of small amounts of stock and securities in a subsidiary as a substitute for ordinary dividends." Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders*, (2d ed.), p. 479; see, also, Surrey & Warren, *op. cit. supra*, at p. 1640. Here, as the Ninth Circuit recognized, "it was impossible to determine whether the final distribution would take place in two, three or even ten

years, depending upon Pacific's need for additional capital" (R. 331). Nothing in the Second Circuit's analysis would have prohibited Pacific from distributing one-tenth of the Northwest stock in each of ten successive years, so long as Pacific had a general plan and evidenced a legitimate business purpose. Yet, that sort of distribution would undoubtedly have been viewed as a dividend, both by Pacific and its shareholders (see R. 130, 135). Or, Pacific, having the same business purpose as it did in this transaction, could have distributed rights to the Northwest stock in eight equal installments, beginning in September 1961, when the first offering was in fact made, and ending in June 1963, when Pacific did offer the remaining 43 percent of the Northwest stock. Had eight such offerings been made, the value of each offering could have been close to the 30 cents per share quarterly dividend Pacific paid after it sold the first block of Northwest stock.[17]

Nor does it suffice to say, as the Second Circuit did (R. 293), that "an adequate restriction" against such use of the spin-off "is already provided by subsection (a)(1)(B)." By its express terms, Section 355 (a)(1)(B) would foreclose only those transactions "used *principally* as a device for the distribution of

[17] The record does not show the value of the rights distributed in 1963. Those distributed in 1961 had a value of approximately $1.86 per share on September 20, the date of distribution. The average value of the rights, while they were available, ranged from $1.56 to $1.98. (R. 140.) Assuming that there was no substantial change in the value of the Northwest stock in the following twenty months, the value of rights to all the stock at the $16 per share price would have been approximately two-thirds higher—for a total in the vicinity of $3.25.

the earnings and profits of the distributing corporation." (Emphasis supplied.) No doubt Pacific, having the same principal purposes as it did in the transacaction actually used, could have made eight equal quarterly distributions of rights. Distribution of the earnings and profits would have been a purpose of Pacific, but it is not clear that it would have been a principal purpose. Cf. *Malat* v. *Riddell,* 383 U.S. 569.

In any event, Congress has decided that Section 355(a)(1)(B) is not by itself "an adequate protection"; Congress otherwise would not have added Section 355(a)(1)(D), since Section 355(a)(1)(B) is virtually the same as the 1951 Act that Section 355 replaces. The 80 percent standard of Section 355 (a)(1)(D), together with the 5-year active business rule of Section 355(b)(2)(B), establish a test that Congress used to distinguish those distributions that may, by design or otherwise, have the effect of a dividend. Section 355(a)(1)(B), in the 1954 Code, offers supplemental protection to the revenue by defeating any "transaction * * * used principally as a device for the distribution" of stock of a long-held operating subsidiary is distributed.

Here, again, Pacific chose to cut one of the "square corners" of Section 355. It could, had it wished, have disposed of all of the Northwest stock in 1961. It preferred to hold 43 percent of the stock until some later date, when it expected to have need for the money it could obtain through selling the stock. That was a perfectly appropriate choice for it to make, but it took the transaction out of Section 355, since

a dividend, even though 80 to 100 percent of

it did not meet the requirement that it distribute either all of the stock of the controlled corporation or "an amount of stock in the controlled corporation constituting control within the meaning of section 368(c)," which is 80 percent.

IV. SHAREHOLDERS WHO SOLD AND DID NOT EXERCISE THE RIGHTS PACIFIC DISTRIBUTED THEREBY REALIZED ORDINARY AND NOT CAPITAL INCOME

There remains the question of the proper tax treatment of the rights which were sold by the taxpayers in No. 760.

1. If Pacific's 1961 disposition of Northwest stock fails to qualify for nonrecognition treatment under Section 355, amounts received on the sale of the stock rights constitute dividend income. See *Choate* v. *Commissioner,* 129 F. 2d 684 (C.A. 2); *Gibson* v. *Commissioner,* 133 F. 2d 308 (C.A. 2); see also *Palmer* v. *Commissioner, supra,* 302 U.S. at 69.

2. There has been a widespread notion that the *Palmer* case decided that the receipt of rights to buy portfolio shares [18] did not constitute income. The Second Circuit relied on this idea in concluding that the proceeds of the rights were capital, if the transaction qualified under Section 355. However, in the *Palmer* case, as we have already pointed out (pp. 26–27, *supra*), the purchase price fixed in the rights was identical with the fair market value of the property offered. Thus, the rights in that case had little or no

[18] "Portfolio" shares refer to stock one corporation owns in another.

value at the time they were declared by the corporate board of directors. It is true that the rights had some value at the time they were received, and that the Court concluded that this value should not be taken into account on receipt. However, the Court clearly recognized that the situation would be different if the purchase price fixed in the rights for the shares offered was less than their fair market value at the time the rights were declared. This Court said (302 U.S. at 69):

> On the other hand such a sale, if for substantially less than the value of the property sold, may be as effective a means of distributing profits among stockholders as the formal declaration of a dividend. The necessary consequence of the corporate action may be in susbtance the kind of a distribution to stockholders which it is the purpose of § 115 to tax as present income to stockholders, and such a transaction may appropriately be deemed in effect the declaration of a dividend, taxable to the extent that the value of the distributed property exceeds the stipulated price. * * *

3. In any event, the method of taxing rights was subjected to comprehensive overhaul by Congress in the Internal Revenue Code of 1954. Section 305 of that Code provided that distributions by a corporation of its own shares, or of rights to acquire its own shares, did not constitute income, except in two minor situations not relevant here. At the same time, Congress provided in Section 301(a) of the Code as follows:

> Except as otherwise provided in this chapter,

> a distribution of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

"[S]ubsection (c)," together with Section 316, directs that such "a distribution of property" is to be taxed as a dividend to the extent of corporate "accumulated earnings and profits."

The term "property" is defined in Section 317(a) in the following language:

> For purposes of this part, the term "property" means money, securities, and any other property; except that such term does not include stock in the corporation making the distribution (or rights to acquire such stock).

Thus, it is clear that the word "property" as used in Section 301(a) includes rights to subscribe to portfolio shares. Such rights are obviously "other property." Moreover, it would not have been necessary to exclude "rights to acquire" "stock in the corporation making the distribution" if rights, generally, were not comprehended in the term "property."

Finally, Section 301(b)(1)(A) provides that "the amount of any distribution" shall include "the fair market value" of property received, and Section 301(b)(3) requires that "fair market value shall be determined as of the date of the distribution."

Thus, it is clear that, under the comprehensive scheme established by Congress in 1954, rights to subscribe to portfolio shares are to be included in income as distributions of corporate property. Moreover, on the basis of the actual language, they are to be in-

cluded as of the date distributed, and at their fair market value on the date they are distributed. The amount so determined constitutes a dividend to the extent of the "earnings and profits" of the corporation.

Thus, under the terms of the statute, the distribution was a dividend, or at least potentially a dividend. Ordinarily, in these cases, there will not be much difference between the value of the rights on the day they are received, and their value on the date they are sold. Analytically, the rights should be considered dividend income on the date distributed. They then become property held by the taxpayer with a basis of the amount of their fair market value on that date, and there is a gain or loss on subsequent sale of the rights measured by the difference between the sale price and the basis. This would be a capital gain or loss, ordinarily short term, since the duration of the validity of rights is generally much less than six months. See Carlson, *Taxation of "Taxable" Stock Rights: The Strange Persistence of Palmer v. Commissioner,* 23 Tax L. Rev. 129.

Although this is the technical analysis of the situation, it is convenient in these cases, where rights are sold, to minimize the amount of computation involved, and to treat the proceeds on sale as being the dividend, rather than the fair market value on the date of the receipt of the rights. In this case, the difference in time between the two events is of no consequence; and the difference in amount is *de minimis.*

4. Even if Section 355 grants nonrecognition to the overall transaction, the proceeds of rights that were sold should be considered ordinary dividend income. The most that can be said, if the transaction did qualify under Section 355, is that Pacific's shareholders received, through the rights to buy the Northwest stock, an option to make one of two decisions. They could pay money to Pacific, and thus continue, through holdings in Northwest, an investment in the telephone business in Oregon, Washington, and Idaho. Or they could sell that option at its market value. Even if the issuance of rights is viewed, in the language of the Second Circuit majority, as a mere "mechanism" for distribution of the Northwest stock, those who sold the rights aborted the mechanical process. Once they sold their rights, they cannot be said in any way to have received stock in Northwest. In this event, they do not qualify for the nonrecognition treatment of Section 355—for Section 355(a)(1) provides that "no gain or loss shall be recognized to (and no amount shall be includable in the income of) such share holder or security holder *on the receipt of such stock or securities.*" (Emphasis supplied.) This obviously refers, in this case, to the Northwest stock; and the taxpayers who sold their rights never received any Northwest stock.

The exceptional treatment of Section 355 is available only to taxpayers who come expressly within its terms, and there is no statutory basis for treating amounts received on the sale of rights as anything other than ordinary income. *Choate* v. *Commissioner,* 129 F. 2d at 689; *Gibson* v. *Commissioner, supra.*

Thus, even if this Court holds that Section 355 allows nonrecognition treatment to those Pacific shareholders who exercised the rights they received to purchase Northwest stock, the Second Circuit should still be reversed to the extent that it held that amounts realized upon the rights that were sold constituted capital gain.

CONCLUSION

The judgment of the Second Circuit should be reversed and the judgment of the Ninth Circuit should be affirmed.

Respectfully submitted.

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FEBRUARY 1968.

APPENDIX

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Internal Revenue Code of 1954, Section 355, 26 U.S.C. 355:

SEC. 355. DISTRIBUTION OF STOCK AND SECURITIES OF A CONTROLLED CORPORATION.

(a) *Effect on Distributees.*—

(1) *General rule.*—If—

(A) a corporation (referred to in this section as the "distributing corporation")

(i) distributes to a shareholder, with respect to its stock, or

(ii) distributes to a security holder, in exchange for its securities,

solely stock or securities of a corporation (referred to in this section as "controlled corporation") which it controls immediately before the distribution,

(B) the transaction was not used principally as a device for the distribution of earnings and profits of the distributing corporation or the controlled corporation or both (but the mere fact that subsequent to the distribution stock or securities in one or more of such corporations are sold or exchanged by all or some of the distributees (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device),

(C) the requirements of subsection (b) (relating to active business) are satisfied, and

(D) as part of the distribution, the distributing corporation distributes—

(i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or

(ii) an amount of stock in the controlled corporation constituting control within the meaning of section 368(c), and it is established to the satisfaction of the Secretary or his delegate that the retention by the distributing corporation of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax,

then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder or security holder on the receipt of such stock or securities.

(2) *Non pro rata distributions, etc.*—Paragraph (1) shall be applied without regard to the following:

(A) whether or not the distribution is pro rata with respect to all of the shareholders of the distributing corporation,

(B) whether or not the shareholder surrenders stock in the distributing corporation, and

(C) whether or not the distribution is in pursuance of a plan of reorganization (within the meaning of section 368(a)(1)(D)).

(3) *Limitation.*—Paragraph (1) shall not apply if—

(A) the principal amount of the securities in the controlled corporation which are received exceeds the principal amount of the securities which are surrendered in connection with such distribution, or

(B) securities in the controlled corporation are received and no securities are surrendered in connection with such distribution.

For purposes of this section (other than paragraph (1)(D) of this subsection) and so much of section 356 as relates to this section, stock of a controlled corporation acquired by the distributing corporation by reason of any transaction which occurs within 5 years of the distribution of such stock and in which gain or loss was recognized in whole or in part, shall not be treated as stock of such controlled corporation, but as other property.

(4) *Cross reference.*—

For treatment of the distribution if any property is received which is not permitted to be received under this subsection (including an excess principal amount of securities received over securities surrendered), see section 356.

(b) *Requirements as to Active Business.*—

(1) *In general.*—Subsection (a) shall apply only if either—

(A) the distributing corporation, and the controlled corporation (or, if stock of more than one controlled corporation is distributed, each of such corporations), is engaged immediately after the distribution in the active conduct of a trade or business, or

(B) immediately before the distribution, the distributing corporation had no assets other than stock or securities in the controlled corporations and each of the controlled corporations is engaged immediately after the distribution in the active conduct of a trade or business.

(2) *Definition.*—For purposes of paragraph (1), a corporation shall be treated as engaged in the active conduct of a trade or business if and only if—

(A) it is engaged in the active conduct of a trade or business, or substantially all of its assets consist of stock and securities of a corporation controlled by it (immediately after the distribution) which is so engaged,

(B) such trade or business has been actively conducted throughout the 5-year period ending on the date of the distribution.

(C) such trade or business was not acquired within the period described in subparagraph (B) in a transaction in which gain or loss was recognized in whole or in part, and

(D) control of a corporation which (at the times of acquisition of control) was conducting such trade or business—

(i) was not acquired directly (or through one or more corporations) by another corporation within the period described in subparagraph (B), or

(ii) was so acquired by another corporation within such period, but such control was so acquired only by reason of transactions in which gain or loss was not recognized in whole or in part, or only by reason of such transactions combined with acquisitions before the beginning of such period.

U.S. GOVERNMENT PRINTING OFFICE: 1968

Supreme Court of the United States

OCTOBER TERM, 1967

Nos. 760 and 781

COMMISSIONER OF INTERNAL REVENUE, *Petitioner*, vs. IRVING GORDON and MARGARET GORDON, *Respondents*.	No. 760

On Writ of Certiorari to the United States Court of Appeals for the Second Circuit

OSCAR E. BAAN and EVELYN K. BAAN, *Petitioners*, vs. COMMISSIONER OF INTERNAL REVENUE, *Respondent*.	No. 781

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

BRIEF OF RESPONDENTS IN NO. 760 AND OF PETITIONERS IN NO. 781

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OPINIONS BELOW

The findings of fact and opinion of the Tax Court in the two consolidated cases (A. 227)[1] are reported at 45 T.C. 71. In No. 760, the opinion of the Court of Appeals for the Second Circuit (A. 275) is reported at 382 F.2d 499. In No. 781, the opinion of the Court of Appeals for the Ninth Circuit (A. 308) is reported at 382 F.2d 485.

JURISDICTION

In No. 760, the judgment of the Court of Appeals for the Second Circuit (A. 306) was entered July 26, 1967. The petition for certiorari was filed by the Commissioner of Internal Revenue ("Commissioner") October 23, 1967, and was granted January 15, 1968.

In No. 781, the judgment of the Court of Appeals for the Ninth Circuit (A. 334) was entered July 7, 1967. Rehearing was denied August 15, 1967 (A. 10). The petition for certiorari was filed by Oscar E. and Evelyn K. Baan ("taxpayers")[2] November 2, 1967, and was granted January 15, 1968.

The jurisdiction of this Court is invoked under section 1254(1) of Title 28 of the United States Code.

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[1]References in this form are to pages of the Consolidated Appendix prepared pursuant to Rule 36.

[2]The term "taxpayers" will likewise be used herein to refer to respondents in Docket No. 760, Irving and Margaret Gordon.

STATUTES INVOLVED

The case directly concerns the application of section 355[3] of the Internal Revenue Code of 1954 (26 U.S.C. 355 (1964 Ed.); 68A Stat. 113-114), which is set forth in Appendix A, infra, pages v to ix.

QUESTIONS PRESENTED

The Pacific Telephone and Telegraph Company ("Pacific"), engaged in the telephone business in California, Oregon, Washington and Idaho,[4] adopted a plan of reorganization to divide its business between its California operations and those in the other three states. As a first step, Pacific formed Pacific Northwest Bell Telephone Company ("Northwest"), to take over the non-California business of Pacific. Then, pursuant to the plan, it distributed all of the stock of Northwest, by issuing pro rata to the Pacific shareholders, in two offerings, short-term transferable rights to purchase all of such stock. More than 95 per cent of the rights were exercised by the same Pacific shareholders to whom they were issued, and all were eventually exercised. The question presented is whether the taxpayers (common shareholders of Pacific), who exercised their Northwest rights to retain their proportionate equity in Pacific and Northwest, thereby received dividend income, despite the provisions of section

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[3]References hereinafter to numbered sections, without further specification, are to sections of the Internal Revenue Code of 1954 (26 U.S.C. (1964 Ed.)).

[4]Pacific also owns all of the stock of Bell Telephone Company of Nevada which operates in Nevada. The Nevada subsidiary and its operations are irrelevant to the cases at bar and hence are disregarded.

355. The Tax Court and the Second Circuit Court of Appeals held that the tax-free spin-off provisions of section 355 applied and that the taxpayers did not receive any dividend income through the exercise of their rights. The Ninth Circuit Court of Appeals sustained the Commissioner's contention that section 355 did not apply, and held that the taxpayers received dividend income equal to the difference between the fair market value of the Northwest stock when the rights were exercised and the amount paid to Pacific.

As a further reason for not applying section 355, the Ninth Circuit Court of Appeals held that the two offerings of the Northwest stock by Pacific were not parts of a single transaction, contrary to the requirements of section 355(a)(1)(D). A subsidiary question is presented whether the Ninth Circuit erred in making this factual determination directly contrary to the determination of the Tax Court, which is amply supported by the record.

In Docket No. 760, taxpayers sold some of their Northwest rights, and the additional question is presented whether the sale resulted in capital gain, as contended by the taxpayers and held by the Court of Appeals for the Second Circuit, or dividend income, as contended by the Commissioner and held by the Tax Court.

STATEMENT OF THE CASE

Summary Statement

In 1961 Pacific, which for many years had engaged in the telephone business in California, Oregon, Washington and Idaho, decided for purely business reasons to

divide the Oregon, Washington and Idaho operations from those in California (A. 35, 49). One of the methods considered by Pacific's management to effect this division was a conventional spin-off which clearly would have qualified under section 355 (A. 182-183). In such a spin-off, assets of the corporation are transferred to a newly organized subsidiary in exchange for stock, which is then distributed to the shareholders of the parent without the surrender by them of stock in the parent corporation. This method was rejected because of obstacles under state corporation law (A. 183-184). Instead, Pacific adopted a plan of reorganization whereby the assets in the three states in the Pacific Northwest were transferred to a new corporation, Northwest, and all of the stock of Northwest was spun off by means of the pro rata issuance to the Pacific shareholders of rights to purchase Northwest stock (A. 100, 103-104). The use of rights at the same time satisfied the needs of Pacific for additional capital for its expanding California operations (A. 104, n.).

Pursuant to the plan, in 1961 Pacific offered 57 per cent of the Northwest stock to its shareholders on the basis of six rights plus $16 for each share of Northwest, and in 1963 all of the remaining Northwest stock on the basis of eight rights plus $16 a share (A. 56, 61). During the 21-day offering period in 1961, the Northwest shares had a market value ranging from $25.25 to $28.25 per share (A. 139).

American Telephone and Telegraph Company ("American"), owned approximately 90 per cent of the stock of Pacific (A. 39). Under the plan, American stated its intention to exercise all of its rights to acquire Northwest

stock (A. 109). When the plan of reorganization had been fully carried out, more than 95 per cent of the Northwest stock was received through the exercise of rights by Pacific shareholders to whom such rights were issued (A. 62, 141). Pacific continued to operate its business in California (A. 35), and Northwest continued the operation of the businesses formerly conducted by Pacific in Oregon, Washington and Idaho (A. 66). To the extent that Pacific common shareholders, such as taxpayers, exercised rights issued to them, they retained their same proportionate interest in the businesses conducted by Pacific in the States of California, Oregon, Washington and Idaho, as before the division, except that instead of owning solely shares of Pacific, they owned shares in Pacific evidencing their interest in the California operations, and shares in Northwest evidencing their interest in the Oregon, Washington and Idaho operations. Not only was there no change in their proportionate equity in Pacific and Northwest, but they had in addition made a cash contribution to the capital of Pacific at the rate of $16 for each share of Northwest stock.

The Commissioner ruled that section 355 did not apply to the distribution of the Northwest stock through the issuance of stock rights (A. 153, 159). In the case of corporate shareholders of Pacific, the Commissioner ruled that they would receive dividend income under section 301(b)(1)(B), if the basis of the Northwest stock in the hands of Pacific was in excess of $16 a share required to be paid in the exercise of rights (A. 153, 159). Since such basis of the Northwest shares was less than $16 per share, corporate shareholders (including American) under

the Commissioner's ruling were not considered as having received any taxable income through the receipt of their Northwest stock (A. 123). However, in the case of individual shareholders, the Commissioner ruled that they received dividend income under section 301 equal to the difference between $16 a share and the market value of the Northwest shares at the time of exercise of their rights (A. 153, 159). The deficiencies involved in these proceedings were determined against the taxpayers on this basis (A. 26).

The Tax Court, contrary to the position taken by the Commissioner, held that section 355 applied to the distribution of the Northwest stock (A. 257). The Commissioner sought review of the *Gordon* case in the Second Circuit and the *Baan* case in the Ninth Circuit. The Second Circuit Court of Appeals affirmed the Tax Court's holding that section 355 applied (A. 295). That court stated that it was evident that the taxpayers' investment remained in corporate solution, merely changed in form, that the additional factor of the payment of $16 per share was in essence a contribution to capital which provided no occasion for the imposition of a tax (A. 284-285). It found, in accordance with the decision of *Palmer v. Commissioner* (1937) 302 U.S. 63, that no distribution of corporate property occurred until the Northwest rights were exercised, and thereupon the Northwest stock was distributed with respect to the Pacific stock (A. 286). It determined that section 355 did not require a single distribution of stock of the controlled corporation and that the distribution of the Northwest stock through two rights offerings was to be considered a single transaction (A. 290-295). It found that

the transactions fully satisfied the purpose of section 355, and that on the contrary, the Commissioner's determination would convert equity capital into ordinary income (A. 285).

The Court of Appeals for the Ninth Circuit, however, held that section 355 did not apply, on the ground that the receipt of the Northwest stock was not a distribution solely of stock or securities with respect to Pacific stock (A. 327). It held that there was a distribution of stock rights taxable as a dividend under section 301 and not of stock or securities, distinguishing the *Palmer* case (A. 319-323). The Ninth Circuit, as an additional ground for reversal of the Tax Court, held that the conditions of section 355(a)(1)(D) were not satisfied. It held that the two distributions were not entitled to treatment as a single transaction, on the ground that "such distributions must not extend over any greater period of time than is reasonably necessary considering the practical problems involved in completing such distributions" (A. 333).

This Court granted certiorari to resolve the conflict (A. 335, 336). The technical questions presented in the terms of section 355 are as follows:

Was the receipt by taxpayers of Northwest stock through the exercise of stock rights a distribution solely of stock or securities with respect to their Pacific stock, within the meaning of section 355(a)(1)(A)?

Did Northwest acquire its business and assets from Pacific in a transaction in which no gain or loss was recognized (section 355(b)(2)(C)), so as to satisfy the active business requirements of section 355(a)(1)(C)?

Did the distributions by Pacific of all of the Northwest stock through two rights offerings in 1961 and 1963 pursuant to a plan of reorganization satisfy the provisions of section 355(a)(1)(D) as distributions of all of the stock in a controlled corporation?

In Docket No. 760 the question is presented whether the proceeds of sale of the Northwest rights are taxable as a dividend, or whether such sale gave rise to a capital gain, as held by the Second Circuit Court of Appeals.

Detailed Statement

Taxpayers Irving Gordon and Margaret Gordon, husband and wife and residents of New York City, throughout 1961 owned 1,540 shares of the common stock of The Pacific Telephone and Telegraph Company ("Pacific") (A. 34, 68).

Taxpayers Oscar E. Baan and Evelyn K. Baan, husband and wife and residents of Sausalito, California, throughout 1961 owned 600 shares of the common stock of Pacific (A. 34, 67).

Pacific is a California corporation which for several decades prior to July 1, 1961, furnished communications services including local and long-distance telephone services in the States of California, Oregon and Washington and a northern portion of Idaho (A. 35).

Throughout 1961 Pacific had outstanding: 820,000 shares of preferred stock, par value $100, entitled to seven votes per share; and 104,756,943 shares of common stock, par value $14-2/7, entitled to one vote per share (A. 36). Pacific also had a long-term funded debt of $902,000,000 (A. 37). In 1961, American Telephone and Telegraph

Company ("American"), a New York corporation, owned about 90 per cent of Pacific's common stock and about 78 per cent of its preferred stock (A. 37, 39). In addition, the remaining portions of Pacific's common and preferred stock were owned by more than 38,000 minority shareholders (A. 39).

Following World War II, Pacific's business expanded enormously, with every prospect of continued growth at the same rate (A. 45-46). Between the end of World War II and January 1, 1961, the number of telephones which it served increased from 2,700,000 to about 8,000,000; its gross investment in telephone plant increased from \$662,000,000 to \$3,402,000,000; and annual operating revenues increased from \$243,000,000 to \$1,120,000.000 (A. 45-46). Pacific was the eighth largest nonfinancial company in the United States (A. 46). Its operating territory included one seventh of the continental United States (A. 182).

Pacific's mushrooming growth during this period required a constant in-pouring of capital funds. In each of the seven 12-month periods which preceded June 30, 1960, Pacific had issued common stock and/or long-term debentures in the total amount of nearly \$1-⅓ billion, averaging almost \$200,000,000 for each of the seven years (A. 47). The prospect of continued growth assured a need for new capital at approximately the same rate in 1961 and the years immediately following (A. 191).

The growth and enormous size of Pacific generated severe administrative problems, and caused much concern that the company was getting too big to do an effective job (A. 88, 211). In 1958, Pacific's Vice President and Comptroller, John O. Einerman, undertook studies looking

toward division of Pacific into two or three corporations (A. 182). These studies culminated in a plan for reorganization, which Pacific's directors adopted on January 27, 1961, on Mr. Einerman's recommendation (A. 49).

The plan of reorganization provided basically for the division of the Oregon-Washington-Idaho business, leaving the California business to be continued by Pacific (A. 102). The plan provided that Pacific would cause a new corporation to be organized in the State of Washington (ultimately named Pacific Northwest Bell Telephone Company and herein called "Northwest") which would issue 30,460,000 shares of \$11 par capital stock, having an aggregate par value of \$335,060,000, and a note to be refunded by permanent-debt financing (A. 50, 52). The objective in this regard was to result in a capital structure for Northwest similar to that of Pacific (A. 54).

The plan provided that Pacific would transfer all of its business and properties in Oregon, Washington and Idaho to Northwest, in exchange for (a) the assumption by Northwest of certain operating liabilities relating to the assets transferred; (b) all of Northwest's capital stock; and (c) Northwest's \$200,000,000 demand note bearing 4-½ per cent interest (A. 52, 103, 104). The advantages of having the business in Oregon, Washington and Idaho operated by a separate corporation based in the State of Washington were considered to be: bringing top authority closer to the communities served, with a board of directors having final authority and drawn from the territory served; better recognition of service needs of each community; closer relations and better understanding as between the company and customers, employees, and govern-

ing authorities; more efficient operations; the assumption of financing and operating problems by Northwest's management; and freeing Pacific's management to concentrate full attention on the needs of California (and, through its subsidiary, Nevada) (A. 88-89).

Before adopting the plan, Pacific's management considered various alternative proposals for distribution of the Northwest shares. One such proposal was the distribution of the Northwest shares to Pacific's shareholders without payment by them of any consideration. This was dropped because of obstacles under California law of which Pacific's management was advised by its counsel[5] (A. 182-184). Since Pacific was advised that the only feasible method of accomplishing the distribution of the Northwest shares to its shareholders, consistent with California law, was through rights offerings, Pacific coupled the stock distribution with the raising of needed capital for its expanding operations in California.

To achieve its purpose, therefore, the plan provided that all of the Northwest stock would be offered to the Pacific shareholders through rights (A. 103-104).

[5] Pacific's attorneys advised that if the Northwest shares should be distributed to Pacific's shareholders without payment of any consideration by them, under California law the distribution would have to be charged to earned surplus, and Pacific had insufficient earned surplus for this purpose. While Pacific's management was advised that it could create a reduction surplus out of capital, against which a distribution of the Northwest shares could be charged, such a reduction surplus would be required under California law to be used first to redeem all of Pacific's preferred shares. Pacific's management was advised and believed that under California law Pacific could not call its preferred shares for redemption. It was not feasible to redeem Pacific's preferred shares by voluntary tender or purchase (A. 183-184).

A first offering of 57.3 per cent of the shares was provided to take place in 1961, with the remainder to be offered in one or two later offerings, as determined by Pacific's board of directors, as Pacific's capital needs developed (A. 108-109).

Pacific's board of directors on January 27, 1961, resolved to submit the plan to Pacific's shareholders for consideration at the annual meeting on March 24, 1961 (A. 49). In February and March, 1961, Pacific requested from the Commissioner of Internal Revenue rulings as to the tax effects of carrying out the plan upon Pacific, American and Pacific's shareholders (A. 71). Rulings (summarized below) were forthcoming June 28, 1961, two days before the closing date of the transaction and the take-over by Northwest of the Oregon, Washington and Idaho business and properties (A. 146, 155).

On March 24, 1961, Pacific's shareholders heard Mr. Einerman's explanation and recommendation of the plan, and approved it, subject to its approval by the appropriate regulatory authorities of the states involved (A. 49).

After obtaining the necessary approvals of the regulatory authorities,[6] Pacific caused the organization of Northwest on March 27, 1961 (A. 50). Pacific was the sole shareholder of Northwest from March 28, 1961, until after

[6]At the time Pacific, and since that time Northwest, were each subject to regulation in each state in which they operated, by a state public utility regulatory authority having jurisdiction over many aspects of the business, including security issues, purchases and sales of property and the like. Both are likewise subject to regulation by the Federal Communications Commission to the extent their business is interstate (A. 35-36).

the rights offering to its shareholders on September 29, 1961 (A. 56).[7]

As stated above, the Commissioner on June 28, 1961, issued a ruling letter (A. 146) in response to Pacific's requests for rulings in February and March. The Commissioner ruled that section 355 would not apply to the receipt by the Pacific shareholders of Northwest stock upon exercise of the rights to be issued by Pacific (A. 153); that the receipt of the Northwest rights by the Pacific shareholders would not result in taxable income to the shareholders (A. 152); that the receipt by the Pacific shareholders of Northwest stock upon the exercise of their rights, in the case of non-corporate shareholders, would result in a distribution of property under section 301 in an amount equal to the excess of the fair market value of the Northwest stock at the time of their exercise of rights over the $16 paid for the stock; and, in the case of corporate shareholders, would result in a taxable distribution of property under section 301 in an amount equal to the excess, if any, of the basis of the Northwest stock in the hands of Pacific over the $16 paid for the stock[8] (A. 152-153).

The above rulings were reaffirmed in all respects by the Commissioner's letter dated November 15, 1962 (A. 158-159).

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[7]On March 28, 1961, Northwest issued 10,000 shares of its stock to Pacific in return for $110,000 in cash (A. 50). An additional 30,450,000 shares of Northwest's stock passed to Pacific, together with the $200,000,000 note, on June 30, 1961 (A. 52).

[8]As later shown (infra, p. 56), the basis of the Northwest stock in the hands of Pacific was less than $16; hence under the Commissioner's ruling corporate shareholders, including American, did not receive a taxable distribution.

Pursuant to the plan, on June 30, 1961, Pacific transferred all of its business and properties in Oregon, Washington and Idaho to Northwest in exchange for the consideration contemplated by the plan. Thereupon, Pacific ceased, and Northwest commenced, operation of the telephone business in Oregon, Washington and Idaho (A. 52-53).

At a meeting of Pacific's directors on August 25, 1961, Mr. Einerman presented his recommendation of an offering price for the first portion of Northwest stock (A. 58). He presented to the board a number of factors for consideration (A. 129-131), aimed generally at solving the practical problems of affording reasonable assurance that substantially all of the rights would be exercised (A. 206-207) and Pacific's immediate capital requirements met (A. 207-209), and that the reorganization could be accomplished as planned with the least disturbance to Pacific's shareholders (A. 192-193). In behalf of Pacific's management Mr. Einerman recommended to the board, after giving appropriate weight to all factors, that the offering price for the Northwest stock then to be distributed be set at $16 plus six rights (A. 131-132). The board approved the recommendation and the rights were issued accordingly (A. 56-57, 58). Mr. Einerman testified that he did not intend to recommend that a dividend distribution be made (A. 188, 190).

As above indicated, the total capitalization of Northwest was arranged in such a way as to maintain substantially the same ratios of stock, aggregate debt and surplus as those of Pacific immediately prior to the transfer of assets (A. 54). The $200,000,000 demand note of North-

west corresponded to the long-term debentures in the capital structure of Pacific (A. 53). The plan provided that within about three years Northwest would refund the demand note through issuance of its own long-term debentures to the public (A. 109-110). Pursuant to the plan, this refinancing was carried out through four issues of 20-year debentures of Northwest of $50,000,000 each, the last issue occurring in December, 1963 (A. 66).

The plan contemplated that American would exercise all of the rights it was entitled to receive and that American, after consummation of the plan, would own about the same percentage of the Northwest stock as its percentage of ownership of Pacific stock (A. 90-91). Pacific's directors and shareholders were advised, at the time of receiving and approving the plan, of this expectation (A. 109).

Pursuant to the plan, on September 29, 1961, Pacific issued to its shareholders of record on September 20, 1961, rights evidenced by assignable warrants to purchase 57.3 per cent of the Northwest stock, on payment of six rights and $16 per share (A. 56-57). This amount of the initial distribution was fixed in order to pass legal control of Northwest to American immediately (A. 209-210). At the same time, the capital to be raised by Pacific in connection with this distribution was considered not in excess of what Pacific could reasonably use in its business operations at that time (A. 208-209). The rights would expire, if not exercised, on October 20, 1961 (A. 57). Both the capital stock of Northwest and the rights were listed for trading on the American and Pacific Coast stock ex-

changes, and trading with respect to each commenced, at first on a when-issued basis, on September 14, 1961 (A. 58).

The Gordons exercised all except four of their 1,540 rights on October 5, 1961, and paid Pacific $4,096, and received 256 shares of Northwest (A. 69). The Gordons sold the remaining four rights, receiving net proceeds of $6.36 (A. 69). In their joint Federal income tax return for 1961, the Gordons reported no income or loss from the receipt, exercise or sale of the Northwest rights or from receipt of the Northwest stock (A. 69). On the day the rights were issued (September 29, 1961), the market value of the Northwest stock as determined by public trading was $26.81, and the market value of each right as similarly determined was $1.77. On October 5, 1961, the day the Gordons exercised their rights, the two values were $26 and $1.66, respectively (A. 139-140).

The Baans exercised all of their 600 rights on October 11, 1961, paid Pacific $1,600 and received 100 shares of Northwest stock (A. 68). In their joint Federal income tax return for 1961, the Baans reported no income or loss from either the receipt or exercise of the Northwest rights or from receipt of the Northwest stock (A. 68). On October 11, 1961, the day the Baans exercised their rights, the market value of the Northwest stock, as determined by public trading, was $26.94 and the market value of the rights as similarly determined was $1.80 (A. 139-140).

As called for by the plan, American exercised all the rights which it received in 1961, and acquired 15,548,140 shares of Northwest. The minority common and preferred

shareholders of Pacific exercised rights to acquire 1,897,-891 Northwest shares (A. 57).

Further pursuant to the plan, on April 22, 1963, Pacific's board of directors resolved to offer to Pacific's shareholders the remaining 42.7 per cent of Northwest stock held by Pacific. The offering price this time was set at $16 plus eight rights per share. Rights were issued on June 12, 1963, exercisable at any time before the close of business on July 3, 1963 (A. 61). As contemplated by the plan, American exercised all of the rights it received, and upon completion of the plan owned about 89 per cent of the capital stock of Northwest (A. 62). The minority common and preferred shareholders of Pacific to whom rights were issued owned another six per cent (A. 141).

As mentioned below, the Tax Court found that the two offerings of Northwest stock were component parts of a single plan and that they must be regarded together as resulting in the disposition of 100 per cent of the Northwest stock (A. 255, n. 4).

On the 1961 consolidated income tax return filed by American and its subsidiaries, the transfer of assets from Pacific to Northwest was treated as a transaction coming under section 351. Since both Pacific and Northwest were included in a consolidated return in the year of the transfer, no gain or loss was reported on that transaction (A. 245). Also, no gain was reported on the sale by Pacific to American of the Northwest shares for which American exercised its rights. Pacific did report gain on the sale of the Northwest shares to Pacific's minority shareholders to the extent of the difference between the $16 price and Pacific's basis for the property transferred to Northwest,

apportioned to the shares as to which the gain was reported[9] (A. 248).

The Gordons, in their 1961 income tax return, reported no income in respect of their receipt, exercise or sale of their rights (A. 69). Treating the difference between $16 per share and the traded value of Northwest stock on the day when they exercised their rights ($26.00) as a dividend, the Commissioner assessed a deficiency of $895.10, in accordance with his earlier ruling letter (A. 26).

The Baans, in their 1961 income tax return, reported no income on the receipt or exercise of their rights (A. 68). Treating the difference between $16 per share and the traded value of Northwest stock on the date of exercise of the rights ($26.94) as a dividend, the Commissioner assessed a deficiency in the amount of $284.44 (A. 228).

On the taxpayers' petitions for redetermination, the Tax Court decided that the taxpayers did not receive taxable dividend income in respect to receipt or exercise of the rights. It found that the two offerings of Northwest stock were component parts of a single plan and that they must be regarded together as resulting in the disposition of all of the Northwest stock previously owned by Pacific (A. 255, n. 4). The court held that if Pacific had distributed the Northwest stock without consideration to its own shareholders, the distribution would have qualified as a classic case of a tax-free divisive reorganization under section 355, and that neither the use of stock rights nor the presence of Northwest's $200,000,000 note required a different result under section 355. The court noted the absence of

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[9] Also involved in the apportionment were the Northwest note and the assumption of liabilities.

any contention that the transaction was used as a "device for the distribution of the earnings and profits" of either Pacific or Northwest (A. 260).

Regarding the Government's contention that section 355 was not satisfied since Pacific did not "distribute" the Northwest stock but rather distributed rights to purchase the Northwest shares, and that the stock of Northwest was in any event not distributed "with respect to its [Pacific's] stock," the Tax Court said:

> "The Government's position is based upon a highly technical and inhospitable reading of the statute that fails to give effect to the basic objective that Congress sought to achieve. This case concededly involves a spin-off. Pacific plainly divested itself of the business which it had conducted in the three northwest states" (A. 262).

The situation, the Tax Court held, was not changed merely because the distribution was conditioned upon payment of $16 a share by the distributees; it was nonetheless a distribution of Northwest stock to the taxpayers "with respect to" their ownership of stock in Pacific. The stock of Northwest was literally "distributed" to the taxpayers, albeit for a consideration, and the statute should not be construed to depart from that literal meaning, where to do so would frustrate the legislative purpose (A. 262).

As for the Government's argument that the subject of the distribution was the rights to subscribe rather than the Northwest stock itself, the Tax Court pointed out that *Palmer v. Commissioner,* supra, 302 U.S. 63 makes it clear that the issuance of the rights is not in itself a dis-

tribution of corporate earnings and profits; if any income were to be charged it would have to be regarded as stemming from the receipt of the Northwest stock on exercise of the rights; but since section 355 was intended to permit the receipt of such stock without tax even where the recipient paid nothing therefor, it would be a distortion of Congressional purpose to impute an intention to tax where the recipient was required in effect to contribute capital to the distributing corporation as a condition to receiving the distributed stock (A. 263).

Continuing with its sentence-by-sentence analysis of section 355, the Tax Court found (1) that the five-year active business requirements were met (A. 264); (2) that the transaction whereby Northwest acquired its business from Pacific was not one in which gain or loss was recognized, in view of the fact that no gain or loss was required to be included in the consolidated return filed by American and its subsidiaries (A. 269); and (3) that as part of the distribution Pacific effectively distributed all of the stock in the controlled corporation (Northwest) held by it immediately before the distribution (A. 270).

Finally, the Tax Court held that the proceeds received by the Gordons from the sale of four rights was dividend income, since shareholders who sold their rights did not come under section 355 in respect thereto (A. 271).

As stated above, on petitions for review the Court of Appeals for the Second Circuit affirmed the Tax Court in all respects (A. 295) except as to the sale of the rights, which the court held came under the capital gains provisions of the Internal Revenue Code rather than the dividend provisions (A. 296). The court noted particularly the

absence of dispute that (1) the Pacific-Northwest corporate division fulfilled a valid business purpose, (2) the method selected by Pacific to accomplish the division was dictated by valid business reasons, and (3) that there was no possibility under the transaction for turning ordinary income into capital gains—the evil which section 355 was designed to prevent (A. 282). While Congress hedged in the use of section 355 with a number of conditions to prevent a tax-avoidance bail-out of earnings and profits, "when the division presents no opportunity for a bail-out, these conditions should not be so construed as to frustrate the basic Congressional purpose" (A. 283).

In summary, the court said it was evident that the taxpayers' investment remained in corporate solution (aside from the $6.36 representing proceeds of sale of rights) and merely changed its form; the only additional factor was the $16-per-share contribution to capital, which was no occasion for the imposition of the tax. Conversely, if the Commissioner should prevail, the taxpayers' equity investment would be turned into ordinary income (A. 284-285). Having in mind these effects, and the fundamental Congressional purpose of taxing income when and as received, the court was satisfied that all of the technical provisions of section 355 were met (A. 285).

The Court of Appeals for the Ninth Circuit disagreed, looking upon section 355 as a very narrowly defined set of conditions which had to be followed, with nothing added or subtracted, if the transaction was to qualify (A. 318). With this approach, the court concluded that while a distribution to the distributing corporation's shareholders without consideration would qualify (A. 320), a distribu-

tion with consideration paid by the shareholders—even though it left the shareholders with less than before—was dividend "income" and therefore taxable; in other words, that it could not constitute a "distribution with respect to" Pacific's stock (A. 327). It considered that a distribution of rights was a distribution of property taxable as a dividend under section 301 (A. 321).

As an independent ground for reversal, while it held that a single distribution was not required under section 355, the court ruled that the two distributions violated a requirement newly conceived by the court that qualified distributions under section 355 could not take longer than is reasonably necessary considering the practical problems involved in completing such distributions (A. 333).

The writs of certiorari bring these divergent views before this Court.

SUMMARY OF ARGUMENT

For compelling business reasons, Pacific adopted a plan to divide its telephone business in four western states between itself and a new corporation, Northwest, while preserving stock ownership of both corporations in the Pacific shareholders. Obstacles under California corporation law prevented Pacific from merely transferring part of its business to Northwest and distributing the Northwest stock pro rata, in the most common form of spin-off (divisive) reorganization. It accomplished the same result

through the mechanism of two rights offerings of all the Northwest stock to its shareholders pro rata, thereby serving the collateral purpose of raising additional capital needed to service Pacific's growth in California.

The stock rights mechanism neither altered the purpose and effect of Pacific's plan as a divisive reorganization, nor served to distribute to the Pacific shareholders any part of the corporate assets or net worth. When the plan was completed, all of the Northwest stock—but nothing else—had been distributed, over 95 per cent of it to Pacific shareholders, representing their same proportionate interest in the business and assets transferred to Northwest. Here was a legitimate divisive reorganization for corporate business reasons, which section 355 was designed to make tax free, entailing none of the tax-avoidance features which section 355 was designed to prevent.

The legislative history of section 355 demonstrates the Congressional purpose to liberalize existing law as to nonrecognition of gain in cases involving mere rearrangement of the corporate structure. Congress intended to permit the widest latitude in the forms and mechanics of divisive reorganizations when effected for sound business reasons, subject to specified safeguards to prevent tax avoidance. Congress was concerned with results, not mechanics, so that the same tax consequences would attach where substantially the same results were achieved. The conditions set forth in section 355 are designed to thwart abuse of the section by disguised distributions of earnings and profits; however, the Commissioner has conceded throughout this case that Pacific's plan of reorganization was *not* a "device" for distributing earnings and profits.

Measured against the broad Congressional objectives and safeguards, the plan fully satisfies the purposes of section 355. To disqualify it because it involved the *payment* of cash *by* the Pacific shareholders is at war with the Congressional purpose to do away with technical niceties of form or corporate mechanics. Even if the Pacific shareholders had *received* cash from Pacific in addition to the Northwest stock, the gain taxed would have been limited to such cash under section 356. Congress could not have intended that they be taxed when they received *nothing* but the Northwest stock, and instead had to *pay out* cash to Pacific.

Neither the receipt nor the exercise of the Northwest stock rights represented any distribution of the earnings and profits of the two corporations. Under prior decisions of this Court, including *Palmer v. Commissioner* (1937) 302 U.S. 63, the mere receipt of stock rights by shareholders is not a dividend, because no distribution of corporate assets results in any practical sense, even though the rights have a market value. The rule of the *Palmer* case is now firmly embedded in the tax law and in established administrative practice. Lower court decisions have long held that stock rights may be used as an incidental corporate mechanism for effecting reorganizations and do not prevent them from qualifying as tax free reorganizations. The *Palmer* principle was applied by the Commissioner in the advance rulings issued to Pacific in the cases at bar.

The Northwest stock rights were but short-term offers, transitory steps to effect the distribution of all the Northwest stock. The only corporate assets transferred by their exercise were the shares of Northwest stock, representing

a changed form of the shareholders' equity in Pacific's assets. Far from diminishing corporate net worth, the exercise of the rights increased net worth by the capital thus paid in to Pacific. Pacific's shareholders were left with two pieces of paper instead of one, to evidence their continued ownership in the same assets. There was nothing here resembling any bail-out of earnings and profits, since the taxpayers' investment remained in corporate solution, augmented by their capital contribution.

A distribution of all of the Northwest stock to the Pacific shareholders without the payment of cash by them, if it had been possible, would clearly qualify as a tax-free spin-off. A simple contribution of cash to the capital of a corporation by its shareholders is likewise a tax-free event. To transmute these two tax-free transactions into taxable income when they are combined in a single plan of reorganization contradicts substance and reality. The Congressional purpose is to tax income. Until the taxpayers dispose of their Northwest stock, they have not enjoyed any income from the receipt of such stock.

The Commissioner's theory in this case has several elements of harshness. It requires the payment of a tax when the shareholders have received nothing out of which to pay the tax, except the evidences of their continuing equity. It seeks to transmute that equity into ordinary income. It produces unrealistic results in regard to the taxpayers' basis in their Pacific and Northwest stock, and Pacific's earnings and profits available for future distribution. In contrast, the taxpayers' theory results in no detriment to the revenue, and fully accords with the reality of the transactions.

The power of the distributees to sell their rights or to sell a part of their stock in either Pacific or Northwest is irrelevant under section 355 in the absence of a prearrangement to sell. If the mere power to sell their equity were the test, no divisive reorganization could ever qualify. Here, over 95 per cent of the Northwest stock in fact went to Pacific shareholders who exercised rights, thereby preserving their equity.

The contention that the phrase "distributes * * * with respect to its stock" in section 355 prohibits the payment by the shareholders of a consideration, has no merit. This phrase in Subchapter C, the corporate provisions of the Code, simply refers to a distribution to shareholders in their capacity as shareholders. The Pacific shareholders received the Northwest stock in their capacity as Pacific shareholders. Neither the provisions of section 355 nor any other provision of the statute expressly prohibits consideration. As this Court said in *Palmer*, a sale of corporate assets to shareholders is literally a distribution of corporate property to them. In contending that the Northwest stock distribution is a "distribution * * * with respect to stock" within section 301 and hence a dividend under that section, the Commissioner contradicts his contention that such distribution does not fit the identical words in section 355.

Pacific and Northwest satisfied the "active business" requirement of section 355, in that no new assets and no new corporation were acquired from others. Internal adjustment of corporate assets, such as Pacific's transfer of assets to Northwest here, are irrelevant to section 355. Further, the gain which might otherwise have been com-

puted on Pacific's transfer was properly "eliminated" in the consolidated Federal income tax return in which Pacific joined. As the Tax Court held, "elimination" of an "unrealized gain" is synonymous with "nonrecognition," a term used throughout the Code which merely denotes that a specified gain or loss is not to be taken into account.

Nothing on the face of section 355 limits the number of distributions of the stock of the controlled corporation, nor their timing. The Tax Court correctly found that Pacific's two distributions, in 1961 and 1963, were integral steps in a single transaction by which all of the Northwest stock passed from Pacific, satisfying the literal requirements of the statute and its purpose. The Commissioner's belated legal argument in the courts of appeals, that only one distribution is permitted under section 355, was properly rejected by both courts. The general doctrine applicable to all reorganizations that integral steps in carrying out a plan of reorganization must be treated as parts of a single transaction is applicable here. The Ninth Circuit committed gross error in ignoring the Tax Court's factual determination, and in holding that the 1961 and 1963 distributions were not parts of a single transaction.

In selling four rights, the taxpayers in No. 760 sold something representing their right to preserve their equity in the 20 per cent of its business and assets which Pacific had transferred to Northwest. The proceeds of the sale should therefore be treated as a capital gain, in accordance with the analogy of section 1234(a) and the anticipatory assignment cases.

ARGUMENT

I

THE RESULT OF THE DISTRIBUTION OF THE NORTHWEST STOCK TO PACIFIC'S SHAREHOLDERS THROUGH THE TWO RIGHTS OFFERINGS WAS A SPIN-OFF REORGANIZATION WHICH CONGRESS INTENDED TO BE TAX-FREE UNDER SECTION 355.

A. Pacific's divisive reorganization was in purpose and effect a tax-free spin-off which Congress intended to permit under section 355.

Pacific, for compelling business reasons, conceived a plan of reorganization to divide the business and assets of Pacific into two corporations, keeping the stock ownership for practical purposes unchanged. The plan contemplated that these two corporations would have separate managements and be owned separately by the Pacific shareholders. Pacific was advised by its attorneys that under the California corporation law it was unable to effect this divisive reorganization by transferring the assets and business of Pacific in the three northwest states to a new corporation, Northwest, and simply distributing the stock of Northwest to the Pacific shareholders pro rata (A. 183). Had it done so, this would have been what the Tax Court correctly referred to as a classic case of a tax-free divisive reorganization or spin-off permitted under section 355 (A. 260). This is undisputed by all concerned.

A spin-off in its common form, as described by the Ninth Circuit (A. 316), is a transaction in which a part of the assets of a corporation is transferred to a new corporation, and the stock of the transferee is distributed to the shareholders of the transferor without surrender by them of any stock in the transferor. The basic elements are the transfer of assets to a newly organized subsidiary and the

receipt of the subsidiary's stock by the shareholders of the parent corporation. The presence here of the first of these basic elements, namely, the transfer of the business and assets of Pacific in the three northwest states to a new corporation, Northwest, is undisputed.

Pacific, however, was precluded by California corporation law from employing the corporate mechanism more commonly used, namely, a transfer of the Northwest stock to its shareholders by means of a dividend out of its surplus. What Pacific could not achieve by direct distribution of the Northwest stock out of its surplus, it was able to accomplish consistently with state law through the mechanism of prorata rights offerings of all the Northwest stock to its shareholders. While the rights served a collateral purpose of raising additional capital for Pacific to meet its expanding needs in California, the rights were essential to accomplish the divisive spin-off of the Northwest stock in a manner consistent with the state corporation law. Through the rights offerings the Pacific shareholders were enabled to receive the Northwest stock which the plan of reorganization contemplated be distributed to them.

The use of the stock rights in no way altered the purpose and effect of the plan of reorganization as a divisive spin-off reorganization. There was no plan proposed, nor was there any intention on the part of Pacific (A. 188, 190), to distribute earnings and profits to its shareholders. The plan contemplated that the shareholders would receive and retain, after the plan was completed, nothing but Northwest stock, in addition to their Pacific stock. After the spin-off of the Northwest stock, the ag-

gregate property and net worth of Pacific and Northwest were in no wise diminished. The primary purpose of the plan of reorganization was to enable the Pacific shareholders to retain the same proportionate interest in the equity of Pacific and Northwest after the reorganization as each had before. This purpose was fulfilled, since the Pacific shareholders, for all practical purposes, retained their same equity in the two corporations. Over 95 per cent of the Northwest stock went to the Pacific shareholders, including taxpayers, through the exercise of the rights issued to them (A. 62, 141).

The Second Circuit properly characterized the transaction as a legitimate spin-off serving only corporate business purposes, which entailed none of the tax-avoidance features that section 355 was designed to prevent (A. 282). The reorganization achieved precisely what section 355 was intended to permit: a division of the assets and business of Pacific for business purposes, and a spin-off of the stock representing such assets and business to the Pacific shareholders.

B. The legislative history of section 355 establishes that the distribution of the Northwest stock fully satisfies the Congressional purposes of that section.

From the Revenue Act of 1918 forward, tax-free divisive reorganizations have been permitted. Such reorganizations took three forms: so-called split-offs, split-ups and spin-offs. These three types of divisive reorganizations in their common forms are described in the opinion of the Ninth Circuit (A. 318).

In a split-up, a corporation transfers substantially all of its assets to two or more corporations and then liqui-

dates, its stockholders surrendering all of their stock in the transferor and receiving the stock in the transferee corporations. In a spin-off, part of the assets of a corporation are transferred to a new corporation, and the stock of the transferee is distributed to the shareholders of the transferor without the surrender by them of stock in the transferor. A split-off is the same as a spin-off, with the exception that the shareholders surrender part of their stock in the parent corporation in exchange for the newly created subsidary.

Until the Revenue Act of 1924, there was no express provision for a tax-free spin-off. Since Congress felt that spin-offs were economically indistinguishable from split-offs and split-ups which could be effected without the recognition of gain under then-existing law, Congress expressly provided for tax-free spin-offs in section 203(c) of the Revenue Act of 1924 (H.Rept. 179, 68th Cong., 1st Sess., p. 14).

It soon became apparent that the form of tax-free spin-off delineated in section 203(c) of the Revenue Act of 1924 could be used as a tax-avoidance device for distributing earnings and profits in the form of capital gains. This device was dealt with, and struck down, by this Court in *Gregory v. Helvering* (1935) 293 U.S. 465. In that case, without any bona fide corporate business purpose and solely for tax avoidance, a corporation transferred securities to a new corporation, the stock of which was distributed to the taxpayer, who immediately liquidated the new corporation. The purpose of the transaction was to obtain the securities as a capital gain rather than as a taxable dividend.

The difficulty, under the statute as it then stood, of distinguishing between spin-offs serving legitimate business needs and those designed for tax avoidance led Congress, in the Revenue Act of 1934, to eliminate spin-offs completely as tax-free divisive reorganizations (S.Rept. 558, 73d Cong., 2d Sess., p. 16). Congress still continued to permit tax-free split-ups and split-offs.

In 1951, however, Congress reinstated tax-free spin-offs, recognizing that it was "economically unsound to impede spin-offs which break up businesses into a greater number of enterprises when undertaken for legitimate business purposes" (S.Rept. 781, 82d Cong., 1st Sess., p. 58). Section 112(b)(11), added in 1951 to the 1939 Code, provided for tax-free spin-offs if they were not principally used as a device for distributing earnings and profits.

In 1954, in enacting the new Internal Revenue Code, Congress thoroughly re-examined the existing law relating to all corporate distributions and adjustments. Subchapter C represented an overhaul of existing law in this area. One of the basic objectives of Subchapter C was to liberalize existing law with respect to the nonrecognition of gain in cases which involve mere rearrangements of the corporate structure.[10] Congress placed in a single section (section 355 involved herein) the provisions dealing with all tax-free

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[10] "The House bill in this area is, in substance, an entirely new statute using few of the terms or concepts with which the courts or the bar have become familiar over the years. Your committee has sought a less extreme approach. Rather than to replace the existing statute, it has sought to rewrite it so as to preserve the terms and concepts of existing law wherever possible. It has, however, not hesitated to depart from the present statute where such departure was necessary in order to *remove unwarranted restrictions on necessary or desirable business transactions* or to preclude

divisive reorganizations—split-offs and split-ups as well as spin-offs.

The legislative history of this section clearly reveals a Congressional purpose to encourage divisive reorganizations effected for legitimate business purposes (H.Rept. 1337, 83d Cong., 2d Sess., pp. 40, A120-A122; S.Rept. 1622, 83d Cong., 2d Sess., pp. 50, 266-267). Subject to safeguards to prevent the abuse of divisive reorganizations as a device to distribute earnings and profits, Congress intended that the widest latitude be permitted in the forms and methods used in carrying out such reorganizations on a tax-free basis. It swept aside the formal distinctions between spin-offs, split-ups and split-offs. Congress evidenced its concern only with results, and not corporate forms or mechanics. Congress plainly desired that the same tax consequences would attach to different types of transactions accomplishing substantially the same result. The House Ways and Means Committee report states:

> "Your committee's bill is designed to insure that the same tax consequences result from the different types of transactions which are available to accomplish substantially the same result" (H.Rept. 1337, 83d Cong., 2d Sess., p. 39).

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the use of avoidance devices which have proved successful under the existing code. Thus, your committee would *liberalize present law with respect to the nonrecognition of gain or loss in cases which involve mere rearrangements of the corporate structure* while at the same time providing less liberal rules in other areas in order to insure that transactions which are in substance; although not in form, dividend distributions by corporations to their shareholders are subject to tax at ordinary income rather than at capital gain rates" (S.Rept. 1622, 83d Cong., 2d Sess., p. 42, emphasis added; to like effect, H.Rept. 1337, 83d Cong., 2d Sess., p. 34).

The Congressional determination to remove impediments to tax-free divisive reorganizations is apparent from the changes made in prior law. By section 355(a)(2)(A), Congress made it no longer necessary to have pro-rata distributions of stock. Section 355(a)(2)(B) dispensed with the necessity for surrendering stock in the distributing corporation. Section 355(a)(2)(C) removed any requirement that the distribution be made pursuant to a plan of reorganization. Under prior law it had been considered necessary to create a new holding company in order to distribute its stock under a tax-free spin-off. Congress eliminated this requirement and permitted the stock of a controlled corporation to be distributed directly on a tax-free basis. Congress even permitted the retention of some stock of a controlled corporation, whereas under prior law it had been considered that all of such stock had to be distributed to qualify as a tax-free spin-off (S.Rept. 1622, 83d Cong., 2d Sess., pp. 266-267). All of these changes, dispensing with formal and mechanical requirements, were made subject to one overriding principle, namely, that the transaction not be used as a device for the distribution of earnings and profits.[11]

Four conditions are enumerated in section 355, each designed to implement the purpose of Congress in thwarting the distribution of earnings and profits. Under section

[11] "While your committee intends generally in section 353 [section 355 as finally enacted] to permit freedom in the distribution of stock of controlled corporations, subsection (b) is included in the bill to insure that tax avoidance will not result by reason of a later disposition of the stock so acquired" (H.Rept. 1337, 83d Cong., 2d Sess., p. A122).

355(a)(1)(A), only stock or securities of a controlled corporation can be received tax free. Under section 355(a)(1)(B) the transaction cannot be used principally as a device for the distribution of earnings and profits. Section 355(a)(1)(C) prevents the acquisition of a business which might be spun off and thereby serve as a means of distributing earnings and profits. Lastly, section 355(a)(1)(D) was designed to prevent the retention of shares in pursuance of a plan having as its principal purpose the avoidance of Federal income tax.

So much did Congress wish to encourage and liberalize tax-free divisive reorganizations, that even where cash or other property is received by the shareholders in addition to stock and securities of a controlled corporation, such receipt will not disqualify the tax-free receipt of the stock or securities. Section 356 provides that only to the extent of the cash or other property received by the shareholders in addition to stock or securities in a divisive reorganization is gain to be recognized to them. Moreover, section 355 permits the tax-free spin-off of preferred stock and securities, whereas under prior law only common stock could be the subject of a tax-free spin-off (S.Rept. 1622, 83d Cong., 2d Sess., p. 267).

Measured against these broad Congressional objectives and safeguards, Pacific's plan of reorganization fully satisfies the purposes of section 355. The plan was conceived and carried out purely for corporate business reasons. It could not possibly be characterized as a "device" for distributing earnings or profits of Pacific or Northwest. To disqualify the Pacific divisive reorganization because it involved stock rights and the *payment* of cash *by* the Pacific shareholders is at war with the Congressional purpose of

permitting tax-free bona fide spin-offs without regard to technical niceties of form or corporate mechanics.

If, in addition to receiving Northwest stock, Pacific shareholders had *received* cash from Pacific, no gain would arise from the receipt of the Northwest stock, and they would be charged with gain only to the extent of the cash received (section 356). Surely Congress did not intend that they should be taxed when they received nothing but the Northwest spin-off stock, and not only had *not received* cash, but had in fact *paid it out.*

Under these circumstances, the Tax Court was clearly correct when it concluded (A. 262):

> "The Government's position is based upon a highly technical and inhospitable reading of the statute that fails to give effect to the basic objective that Congress sought to achieve. This case concededly involves a spin-off. Pacific plainly divested itself of the business which it had conducted in the three northwest states. Had it distributed the Northwest stock directly to its stockholders without consideration there would clearly have been the type of divisive reorganization contemplated by the statute, at least as far as subparagraph (A) is concerned. And, in our view, the situation is not changed merely because that distribution was conditioned upon payment of $16 a share by the distributees. It was nonetheless a distribution of Northwest stock to these petitioners, stockholders in Pacific, made 'with respect to' their ownership of stock in Pacific. If Congress had intended that a distribution of the Northwest stock be treated as tax-free when made without consideration, it is inconceivable that it could have intended the transaction to result in taxable income to the distributees where they *paid out* money in connection

with receiving such stock. The stock of Northwest was literally 'distributed' to petitioners, albeit for a consideration, and we hold that the statute should not be construed so as to depart from such literal meaning, where to do so would frustrate the legislative purpose" (emphasis by the court).

C. The distribution of the Northwest stock did not and could not effect any distribution of earnings and profits by Pacific to its shareholders.

The Commissioner has contended that section 355 does not apply to the distribution of the Northwest stock. His position, concurred in by the Ninth Circuit, is that taxpayers who exercised their rights to acquire the Northwest stock thereby received dividend income, taxable under section 301. That section provides that a distribution of property by a corporation to a shareholder with respect to its stock will constitute a dividend to the extent that it is a distribution of earnings and profits.

In the classic case of *Eisner v. Macomber* (1920) 252 U.S. 189, this Court, in examining the nature of dividend income, stated that no dividend income is received by a stockholder if he receives nothing out of the company's assets for his separate use and benefit. This was followed by the case of *Miles v. Safe Deposit Co.* (1922) 259 U.S. 247, in which the Court dealt with the question whether the receipt of stock rights constituted the receipt of dividend income. The Court said (pp. 251-252):

> "It is evident, we think, that such a distribution [of rights] in and of itself constituted no division of any part of the accumulated profits or surplus of the company, or even of its capital; it was in effect an opportunity given to stockholders to share in con-

tributing additional capital, not to participate in distribution. * * * This privilege of itself was not a fruit of stock ownership in the nature of a profit; nor was it a division of any part of the assets of the company.

"The right to subscribe to the new stock was but a right to participate, in preference to strangers and on equal terms with other existing stockholders, in the privilege of contributing new capital called for by the corporation * * *."

While the *Safe Deposit Co.* case dealt with rights to acquire stock of the same corporation, the same rule that the mere receipt of stock rights is not income applies equally to rights to purchase the stock of another corporation. This was established by the decision of this Court in *Palmer v. Commissioner* (1937) 302 U.S. 63, which resolved the conflicting views of the lower courts on this point. In *Palmer* the Court stated (302 U.S. 71):

"*First.* The mere issue of rights to subscribe and their receipt by stockholders, is not a dividend. No distribution of corporate assets or diminution of the net worth of the corporation results in any practical sense. Even though the rights have a market or exchange value, they are not dividends within the statutory definition. Cf. *Miles v. Safe Deposit & T. Co.*, 259 U.S. 247; *Helvering v. San Joaquin Co.*, 297 U.S. 496; *Helvering v. Bartlett, supra.* They are at most options or continuing offers, potential sources of income to the stockholders through the sale or exercise of the rights. Taxable income might result from their sale, but distribution of the corporate property could take place only on their exercise. The question, then, is whether the distribution which results from the

exercise of the rights must be regarded as a dividend * * *."

To the same effect:

Choate v. Commissioner of Internal Revenue (2 Cir. 1942) 129 F.2d 684.

The decision of this Court in *Palmer* is as sound today as when it was first pronounced some 30 years ago. The rule that no dividend income is received merely on the receipt of stock rights has been firmly embedded in the tax law ever since. This has been reflected in the long-established administrative practice of the Internal Revenue Service. G.C.M. 25063 (C.B. 1947-1, 45, 47) states:

> "* * * this office is of the opinion that the stock rights * * * are taxable as dividends to the stockholders only when exercised by them. Prior to that time, there has been no distribution by the corporation and the statutory definition of a dividend has not been met."[12]

In other types of reorganizations where rights have been an incidental part of the reorganization, the courts have held that they are no barrier to a tax-free reorganization. Illustrations of this principle may be found in such cases as *Edgar J. Hesslein* (1930) 21 B.T.A. 61, affirmed per curiam (2 Cir. 1931) 53 F.2d 1081. Similarly in *George L. DeBlois et al., Executors* (1928) 12 B.T.A. 1138, affirmed (1 Cir. 1929) 36 F.2d 11, it was held that a tax-free reorganization occurred which prevented the deduction of a loss, when the shareholder was required

[12]Consistently, there is no loss sustained on the lapse of rights (G.C.M. 25063, supra, p. 48). In the instant cases, approximately 216,000 Northwest stock rights lapsed (A. 141).

to invest cash in the newly organized corporation through stock rights. There the Board of Tax Appeals stated (12 B.T.A. 1148):

> "The primary idea as to these shareholders [who invested cash] was that they should be enabled to carry on their interest in the business, and the cash requirement was incidental. No stranger could purchase the new securities at the same figure. The holder of stock rights is in a position somewhat analogous. When he buys his new stock he commingles it with the old and both old and new take the same basis on future sale or disposition."

To the same effect are *First National Bank of Champlain, N.Y.* (1930) 21 B.T.A. 415 (loss deduction denied); *Coleman v. Commissioner of Internal Revenue* (10 Cir. 1936) 81 F.2d 455 (loss deduction denied); *Albert W. Russel* (1944) 3 T.C.M. 817; and *Realty Corp.* (1946) 5 T.C.M. 868.

These cases recognize that where stock rights are an incidental corporate mechanism for effecting a reorganization, the presence of stock rights will not prevent the transaction from qualifying as a reorganization. Here, the stock rights merely accomplished the purpose of completing the divisive reorganization by permitting the distribution of the Northwest stock to the Pacific shareholders.

The *Palmer* principle was applied by the Commissioner in ruling on the tax effects of the Pacific plan of reorganization. The Commissioner stated in his ruling letter of June 28, 1961, reaffirmed on November 15, 1962:

> "The receipt by the shareholders of the Pacific Company of rights to purchase shares of stock of

the Northwest Company will not result in taxable income to the shareholders" (A. 152, 158).

The stock rights created by Pacific and issued to its shareholders were mere offers of Northwest stock. Until these offers were accepted, i.e., by exercise, there was no transfer of corporate assets by Pacific to its shareholders. The only corporate assets transferred by Pacific under the stock rights offerings were the shares of Northwest stock, which were a mere changed form of Pacific's ownership of the business and assets in the three northwest states. The mere creation and issuance of the rights by Pacific in no wise diminished its property or net worth. When the plan of reorganization was completed, far from any diminution of the net worth of Pacific and Northwest by the distribution of dividends as the Commissioner contends, the total property and net worth of Pacific and Northwest had been *increased* by the capital paid into Pacific by its shareholders in the exercise of their rights. The taxpayers received none of Pacific's assets other than the Northwest stock which, under section 355, they were entitled to receive tax free.

In holding that the taxpayers' receipt of the stock rights represented a taxable dividend (A. 321), the Ninth Circuit not only misconceives the essential nature of stock rights as *Palmer* clearly set forth, but also ignores the substance of the plan of reorganization. The rights issued in 1961 and 1963 expired within a period of approximately three weeks from the date of issuance. They were extinguished in their exercise. By their terms, they could not survive completion of the plan of reorganization. The rights were mere transitory steps to effect the distribution of the North-

west stock to the Pacific shareholders (*Helvering v. Alabama Asphaltic Limestone Co.* (1942) 315 U.S. 179, 184-185). As the Second Circuit so properly observed (A. 276-277):

> "[W]hen Pacific decided to have its assets held by two corporations instead of one, the position of the Gordons remained unchanged. They merely needed to have another piece of paper to evidence their same fractional asset ownership. This, in substance, Pacific supplied. However, as a result of the transaction, the Commissioner of Internal Revenue (the Commissioner) has assessed an income tax against the Gordons who properly ask, probably in some wonderment, how this corporate change of asset ownership brought income to them, and if so, where is it?"

The conditions laid down in section 355 were intended by Congress to prevent the distribution of earnings and profits. There is nothing here resembling any bail-out of earnings and profits. This corporate division presents no opportunity for a bail-out. On the contrary, if the Commissioner and the Ninth Circuit are sustained, ordinary dividend income will be fabricated out of the retention of taxpayers' investment in the equity of Pacific and Northwest. As the Second Circuit so rightly stated (A. 284-285):

> "Here it is evident that the taxpayers' investment remained in corporate solution (aside from the $6.36) and merely changed its form. The only additional factor was the payment of $16 per share which was in reality tantamount to a contribution to capital and that, of course, is no occasion for the imposition of a tax. Nor was there any opportunity for the taxpayers to use this transaction for a bail-out of earn-

ings and profits. On the other hand, if the Commissicner prevails, taxpayers' equity investment will be turned into ordinary income."

D. Coupling the distribution of the Northwest stock with the payment of capital to Pacific does not create taxable dividend income out of the tax-free distribution under section 355.

The exercise of the rights required the payment of cash to Pacific. The injection of this additional element in the distribution of the Northwest stock is the basis for the Commissioner's main argument that the transaction does not qualify as a tax-free spin-off.

It is beyond dispute that a distribution of all the Northwest stock to the Pacific shareholders without the payment of cash by them to Pacific would have qualified as a tax-free spin-off under section 355. It is also clear that a simple contribution of cash to the capital of a corporation by shareholders in proportion to their stock ownership cannot under any circumstances be considered to give rise to taxable income to the contributing shareholders. Thus, we have here two transactions, which separately considered would not give rise to taxable income—a contribution of capital and a distribution of the stock of a controlled corporation to the shareholders of the distributing corporation. Paradoxically, the Commissioner seeks to transmute these two tax-free transactions into taxable income.

To predicate taxable income on the exercise of rights requiring the payment of additional capital into Pacific contradicts substance and reality. Far from *receiving* any benefit in the form of cash or other property which might provide an appropriate occasion for the imposition of

a tax on income, taxpayers had *paid out* money. In doing so they merely preserved what they had before, albeit in the form of stock certificates of two corporations instead of one. In practical effect, the transactions here involved are no different than a distribution by Pacific of the Northwest shares directly to the taxpayers, accompanied by a capital assessment levied on them at the rate of $16 for each Northwest share received.

The Second Circuit properly held that Congress, in enacting sections of the Code relating to corporate changes, must be presumed to have adhered to the fundamental purpose of taxing income. Not until the taxpayers disposed of their Northwest stock would they realize anything from the receipt of such stock. As was stated by the Tax Court (A. 263):

> "But Section 355 was intended to permit the receipt of such stock without tax even where the recipient paid nothing therefor, and we think it would be a distortion of Congressional purpose to impute an intention to impose the tax where the recipient was required in effect to contribute to the capital of the distributing corporation as a condition to receiving the distributed stock."

E. The Commissioner's theory results in unrealistic tax effects from the standpoint of the incidence of the tax, the basis of the Northwest stock and the earnings and profits of Pacific and Northwest. Conversely, the tax effects of taxpayers' contentions accord with reality and do not permit any tax avoidance.

Under the Commissioner's theory, the incidence of the tax would fall when the shareholders had received no more than evidences of their continuing equity in the

spun-off business and assets, and were financially out-of-pocket. The exercise of the stock rights in actuality represented a financial burden rather than a financial benefit to the taxpayers. On the other hand, if section 355 is applied to the receipt of the Northwest stock, there will be no tax until the taxpayers sell their Northwest stock and in fact realize income out of which an income tax can be paid.

The Commissioner's theory has an added element of harshness. It converts the taxpayers' equity into ordinary dividend income. In reality, the shareholders' gain, when they do in fact realize it by sale or exchange of their equity, is and should be treated as a capital gain.

Under the Commissioner's theory, the basis of the taxpayers' Northwest stock is $16 a share (the amount paid in exercise of their rights), plus the amount treated as taxable income (A. 160). The original cost basis of their Pacific stock under his theory would remain unchanged. Such a result fails to reflect two important changes with respect to the Pacific and Northwest stock, namely, the transfer of 20 per cent of the assets of Pacific to Northwest, and the investment of an additional $480,000,000 in Pacific.

On the other hand, the application of section 355 requires an allocation of basis under section 358(b). This allocation, contrary to the Commissioner's position, would take into account not only the original investment of the taxpayers in their Pacific stock, but also the additional capital paid into Pacific. The taxpayers' total investment thus arrived at would be allocated between their Pacific

and Northwest stock in proportion to the relative market value of such stock.

A further anomaly is presented by the effect of the Commissioner's theory on the earnings and profits of Pacific and Northwest. Such earnings and profits would be reduced under section 312 by the amount of dividend income deemed to be taxable to the Pacific shareholders through the exercise of their rights, despite the fact that all of the assets and property of Pacific and Northwest were still in corporate solution and available for future distribution as taxable dividends to the shareholders. Under the taxpayers' contentions, on the other hand, the full amount of earnings and profits of Pacific and Northwest remain, as they are in fact, undiminished and subject to taxation when and as actually distributed to the shareholders.

In no way would the application of section 355 to the receipt of the Northwest stock be detrimental to the revenue; no tax avoidance would result. On the contrary, its application to the receipt of the Northwest stock would produce tax effects which accord with reality. The oft-repeated admonition that taxation is eminently practical should be heeded here, and the transactions given a tax effect which accords with practical results.

F. The spread between the offering price and the market value of the Northwest stock was the means of effecting the distribution of the Northwest stock to the Pacific shareholders and did not represent a dividend.

The Ninth Circuit's determination that a distribution of the Northwest stock for no consideration would *not* constitute a taxable dividend, but that a distribution for

a "substantial" consideration less than market value *is* a taxable dividend, presents an unsupportable anomaly.

When Pacific transferred the business and assets in the three northwest states to Northwest, the Northwest stock, which Pacific then held, represented 20 per cent of the equity of Pacific. To effect a distribution of the Northwest stock to the Pacific shareholders, Pacific had no alternative but to offer the Northwest stock to the Pacific shareholders pro rata. In establishing an offering price of $16 a share for the Northwest stock, approximately 40 per cent below the market value of the Northwest stock, Pacific aimed directly at the distribution of the Northwest stock to its shareholders by inducing them to exercise their rights.

The results achieved through the spread used in the rights offering speak for themselves. Over 95 per cent of the Pacific shareholders to whom the rights were issued received their proportionate amount of the Northwest stock through the exercise of rights. The Ninth Circuit stated, however, that the existence of the spread between the offering price and the market value of the Northwest stock evidenced an intention to declare a dividend. The reasoning of the Ninth Circuit presents an anomaly. Had the Northwest stock been offered by Pacific to its shareholders with a maximum spread, i.e., no payment of cash whatever, the Pacific shareholders would have been able to receive the Northwest stock tax free under section 355. The logic of the Ninth Circuit's reasoning compels the conclusion that a maximum amount of dividend income would result, if the offering price was a nominal amount, but income would entirely disappear if the shareholders

paid nothing. The Ninth Circuit must have been aware of the infirmity of its position, since it attempted to qualify its conclusion by referring to "substantial cash payments" (A. 326).[13] The test of substantiality of the cash required for the exercise of rights finds no support in law or in logic. The tax effect of the exercise of stock rights in a reorganization should not and cannot turn on such a vague and indefinite concept.

The Committee Reports on section 355 and the related reorganization provisions disclose a clear intent to permit divisive reorganizations to be effected with known tax consequences. The uncertainties that would result from the test laid down by the Ninth Circuit are sufficient to call for its rejection. More important is the fact that the spread between the offering price and the market value of the Northwest stock was nothing more than a means whereby a portion of the Pacific shareholders' equity in Pacific was passed on to them in the form of Northwest stock. Since they were entitled to receive, tax free under section 355, part of their Pacific equity in the form of Northwest stock, no other result is called for here.

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[13] Far from supporting the Ninth Circuit's conclusion, the qualification serves to destroy it. Assuming a market value of the Northwest stock of $26 per share, the Ninth Circuit would find *no* dividend in the case of a distribution without any consideration; a dividend of $10 in the case of a distribution with a "substantial" payment by the shareholder of $16 per share; and either no dividend or a $25 dividend in the case of a distribution with a cash payment of $1 per share; depending on whether the Ninth Circuit deemed the $1 per share payment to be "substantial" or not.

G. Transferability of the stock rights does not take the transaction out of section 355.

In refusing to apply section 355 to the divisive reorganization accomplished by Pacific, the Commissioner and the Ninth Circuit make a point of the transferability of the Northwest stock rights. The Ninth Circuit did not decide that the "transferability of stock rights would, without more, run counter to the overall concept of section 355" (A. 326). It concluded, however, that Congress was unwilling to treat as tax free a distribution "effectuated by means of transferable stock rights, the exercise of which required substantial cash payments" (A. 325-326).

Section 355 could not more plainly evidence the intention to permit tax-free spin-off reorganizations, despite transferability by the distributees, than by the following provision:

> "* * * (but the mere fact that subsequent to the distribution stock or securities in one or more of such corporations are sold or exchanged by all or some of the distributees (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device [for the distribution of earnings and profits])" (sec. 355(a)(1)(B)).

The fact that the rights were assignable in no way alters the substance and purpose of the plan to distribute the Northwest stock to the Pacific shareholders. Consistent with the interests of the minority Pacific shareholders was the recognition by Pacific that some of the shareholders might not be in a position to exercise their rights and thereby preserve their proportionate interests in Pacific

and Northwest. Since American had expressed its intention to exercise all of its rights, transferability of its rights, representing 90 per cent of the rights issued, was academic. Transferability merely permitted some of the minority Pacific shareholders, not in a position to exercise their rights, to realize on the portion of their equity represented by the Northwest stock, through a sale of rights.

If salability of part of a shareholder's equity could defeat the operation of section 355, such a rule would void each and every attempted tax-free divisive reorganization, as the Second Circuit pointed out. The limitation of continuity of interest should be applied to the actual result, and here, continuity was fully satisfied (A. 288; cf. *Miles v. Safe Deposit Co.*, 259 U.S. 247, 253).

All of the elements of a tax-free spin-off are present in full accordance with the legislative purposes and Congressional intent of section 355. It remains only to examine the highly technical points urged by the Commissioner in his contentions that certain conditions of section 355 were not met.

II

THE DISTRIBUTION OF THE NORTHWEST STOCK BY PACIFIC CONFORMS IN ALL RESPECTS TO THE CONDITIONS AND REQUIREMENTS OF SECTION 355.

As shown above, Pacific's reorganization had all the formal aspects and all the practical and economic effects of a spin-off: part of the operating assets of Pacific were transferred to a new corporation in exchange for its

stock; that stock was transferred to Pacific's shareholders without their surrendering any Pacific stock; there was no purpose or effect of distributing earnings or profits. But instead of viewing the application of section 355 to the transaction in the light of its broad purposes, the Ninth Circuit, as a basis for its conclusion that the statutory requirements were not met, turned to a hypertechnical and narrow construction of isolated words and phrases of the section, out of harmony with the Congressional intent.

The Tax Court properly observed (A. 260) that the distribution of the Northwest stock would present a classic case of divisive reorganization under section 355, absent the use of stock rights and the receipt by Pacific of a promissory note of Northwest. But these variations from the classic form of spin-off neither disturb the substance of the transaction as a precise fulfillment of the statutory purposes embodied in section 355, nor do they violate any of the conditions or requirements of that section.

A. Pacific "distributed" the Northwest stock to taxpayers "with respect to its stock" as required by section 355 (a)(1)(A).

The essence of section 355(a)(1)(A) as it applies to the cases at bar, is:

> "If * * * a corporation distributes to a shareholder, with respect to its stock * * * solely stock or securities of a corporation * * * which it controls * * *."

The Second Circuit, relying on *Palmer,* had no difficulty in finding a distribution of the Northwest stock to Pacific's shareholders with respect to Pacific's stock. The Ninth

Circuit's theory is not so clear; at one point it concludes that the Northwest stock was not distributed with respect to Pacific's stock but was distributed with respect to the taxpayers' ownership of that stock *plus* the payment of \$16 per share (A. 320); at another point it treats the subject of the distribution as not the stock, but the rights (A. 319, 321). In neither aspect, we submit, was the court correct.

Despite the Ninth Circuit's labored construction, the phrase, "distributes * * * with respect to its stock" is a simple and obvious term. It refers simply to a distribution to a shareholder in his capacity as a shareholder. The Senate Finance Committee in its report on the 1954 Code (S.Rept. 1622, 83d Cong., 2d Sess., p. 231) so stated:

> "Subsection (a) of section 301 provides that a distribution of property (as defined in sec. 317(c)) made by a corporation to a shareholder with respect to his stock shall be treated in the manner provided in subsection (c) of section 301. Subsection (a) accordingly makes clear that section 301 has applicability *only to distributions of property to shareholders in their capacity as such*" (emphasis added).

The Treasury Regulations echo this interpretation (Income Tax Regs. sec. 1.301-1 (c)):

> "Section 301 is not applicable to an amount paid by a corporation to a shareholder unless the amount is paid to the shareholder in his capacity as such."

The essence of the plan for reorganization was that the Pacific shareholders—in their capacities as such—should receive the rights, and by answering the need for a con-

tribution of capital to Pacific, receive the stock and thus preserve their same equity in all of the assets.

The Ninth Circuit advanced an entirely new concept—which the Second Circuit observed was nowhere supported by any authority (A. 286)—that the phrase "distributes with respect to its stock" in section 355 is a term of art with a consistent meaning throughout the Code, which excludes distributions with a cash consideration (A. 320-321). We agree that the phrase is a term with a consistent meaning throughout the Code, but contrary to the Ninth Circuit, that meaning embraces distributions with a consideration, cash or otherwise.

It should be noted that section 355 does not in express terms exclude a cash consideration paid by the distributee shareholder. On the contrary, the language relied on by the Ninth Circuit, in its ordinary meaning, includes transactions in which a cash consideration is paid to the distributing corporation. The Ninth Circuit conceded that this Court in *Palmer,* over 30 years ago, said that a sale of corporate assets to shareholders is in a literal sense a distribution of its property (302 U.S. 69). (This statement was made in *Palmer,* moreover, in connection with the receipt of stock by a shareholder through the exercise of stock rights.) The Ninth Circuit brushed *Palmer* aside by saying:

> "* * * we do not believe that it is the kind of distribution contemplated by section 355" (A. 320).

On this unsupported basis, the court expressed its theory that the cash consideration disqualified the distribution of the Northwest stock as a distribution "with respect to * * * stock" under section 355.

Not only does section 355(a)(1)(A) use the term "distributes" as commonly understood to include "sales" to shareholders,[14] but by its express language it embraces "exchanges." Section 355(a)(1)(A)(ii) reads "distributes to a security holder, in exchange for its securities, solely stock or securities of a corporation." Section 355 (a)(1)(A)(i) also includes exchanges, since by virtue of section 355(a)(2), a distribution thereunder may include an exchange of stock for stock in the distributing corporation. By express language, therefore, the term "distributes" in section 355(a)(1)(A) includes exchanges of stock or securities for stock (either preferred or common) and exchanges of stock or securities for securities represented by long-term notes, bonds or debentures. No reason is suggested why exchanges involving all these types of consideration would be expressly included while distributions of stock involving a cash consideration would not be included. Such an anomalous reading is wholly out of harmony with the broad purposes of section 355.

The well-understood meaning of the phrase "with respect to stock" is revealed by an examination of the parallel provisions of section 301 (ante, p. 53). Despite its contrary claim, the Ninth Circuit's conclusions that taxpayers received a dividend distribution with respect to their Pacific stock under section 301, but not a distribution with respect to their Pacific stock as provided in

[14]It should be noted that—unlike a sale to a third party—where a cash consideration is paid by a shareholder to a distributing corporation, the shareholder through his stock ownership retains an interest in the amount of cash paid.

section 355 (A. 321), are self-contradictory.[15]

The Ninth Circuit's attempt to explain why essentially the same language in these two sections should have different meanings (A. 321) is wholly unsatisfactory. Its

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[15] In attempting to escape this contradiction, the Ninth Circuit states that the subject of the distribution was not the Northwest stock but the Northwest stock rights issued by Pacific to its shareholders without a cash consideration. In this, the Ninth Circuit not only departs from the rule of the *Palmer* case, but contradicts the very ruling of the Commissioner which it purports to uphold. The Commissioner's ruling specifically held that the subject of the distribution was not the Northwest rights but rather the Northwest stock. The applicable rulings were as follows (A. 152-153):

> "The receipt by the shareholders of the Pacific Company of rights to purchase shares of stock of the Northwest Company will not result in taxable income to the shareholders.
>
> "No taxable income will result to the shareholders of the Pacific Company by reason of holding the above-described rights to purchase shares of stock of the Northwest Company until the date of expiration of the rights, without having exercised, sold or exchanged them.
>
> "The full amount realized by the shareholders of the Pacific Company upon the sale or exchange of the above-described rights to purchase shares of stock of the Northwest Company will constitute ordinary income to the shareholder so selling or exchanging the rights.
>
> "The receipt by the shareholders of the Pacific Company of stock of the Northwest Company upon the exercise of the above-described rights, in case of each shareholder which is not a corporation, will result in a distribution of property under section 301 of the Code in an amount equal to the excess, if any, of the fair market value of the stock of the Northwest Company at the time of the exercise of the rights over the amount paid for the stock; and, in the case of each shareholder which is a corporation, will result in a distribution of property under section 301 in an amount equal to the excess, if any, of the basis of the stock of the Northwest Company in the hands of the Pacific Company at the time of the exercise of the rights over the amount paid for the stock, assuming the basis of such stock is less than its fair market value."

Since the basis of the Northwest stock in the hands of Pacific was *less* than the offering price, all of the corporate shareholders of Pacific (including American) were treated as *not* having received a dividend from Pacific upon the exercise of their rights.

mere reference to the fact that section 355 relates to a distribution of "solely stock or securities," whereas section 301 relates to a distribution of "property," provides no explanation. The Ninth Circuit's reasoning that there is a difference between sections 301 and 355 as to what the shareholder may *pay* as consideration, because of a distinction in the two sections as to what the shareholder may *receive*, is an utter non sequitur.[16] The difference in what a corporation distributes affords no definition of what the distributing corporation may receive *(Securities Co. v. Commissioner of Internal Revenue* (2 Cir. 1933) 64 F.2d 330; *Albert W. Russel* (1944) 3 T.C.M. 817; *Realty Corp.* (1946) 5 T.C.M. 868).

It is clear that the Commissioner has interpreted section 301 to include distributions involving the transfer of corporate property to shareholders for cash at less than market value. Section 1.301-1(j) of the Income Tax Regulations provides that in the case of a transfer of property by a corporation to a shareholder for an amount less than its fair market value, such shareholder shall be treated as having received a dividend under section 301. The Ninth Circuit's reasoning, that such "treatment" indicates that the transaction was not strictly a distribution under section 301 (A. 322, n. 12), simply will not bear analysis. The Commissioner's regulation is interpretative of the statute *(Timberlake v. Commissioner of Internal Revenue* (4 Cir. 1942) 132 F.2d 259). The Commissioner has no power by

[16]"Yet the payment of cash did not take the transaction out of section 203(b)(2), for the word 'solely' is aimed at what is received in exchange and not at what is handed over in order to secure participation in a reorganization" (*Securities Co. v. Commissioner of Internal Revenue* (2 Cir. 1933) 64 F.2d 330, 331).

regulation to convert into a distribution something that is not a distribution. This regulation supports the position of the Second Circuit, consistent with the *Palmer* case, that the cash consideration involved in the receipt of the Northwest stock by the taxpayers does not make such receipt any less a distribution to taxpayers with respect to their Pacific stock.

B. The transaction was not used principally, or at all, as a device for the distribution of the earnings and profits of either Pacific or Northwest (section 355(a)(1)(B)).

The major restriction on spin-off distributions carried over by the 1954 Code from prior law is the provision of section 355(a)(1)(B) that:

> "* * * the transaction [must not be] used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both * * *."

At no time in the presentation or argument of these cases has the Commissioner even suggested that Pacific's plan of reorganization was a device to distribute its earnings and profits, or those of Northwest. As the Tax Court held,

> "Subparagraph (B) is not involved at all since there is no contention that the transaction was used as a 'device for the distribution of the earnings and profits' of either Pacific or Northwest" (A. 260).

C. The requirements of continued active conduct of the business, both before and after the spin-off, were met (sections 355(a)(1)(C), (b)(1)(A), (b)(2)(B) and (C)).

The active business requirements set forth in section 355(b) are that the trade or business spun off must have

been conducted for the previous five years, and that such trade or business must not have been "acquired" within such five-year period "in a transaction in which gain or loss was recognized in whole or in part" within the meaning of section 355(b)(2)(C). As the Second Circuit stated, the theory underlying this requirement was the prevention of the temporary investment of liquid assets in a new business in preparation for a section 355 division (A. 289). The reasoning was that, if the new business must be operated for at least five years, there would be little incentive to use the device for tax-avoidance purposes. To safeguard against the possibility of purchasing a business which had been in existence for over five years and then distributing the stock in place of a dividend, subsections (b)(2)(C) and (D) of section 355 excluded the acquisition of a trade or business in which gain or loss was recognized.[17] Beyond question, the businesses which Pacific had conducted in the four states for many decades had to be continued after the reorganization. Further, it is undisputed that the dangers intended to be dealt with by section 355(b) were not involved in the legitimate divisive reorganization which occurred here.

Both the Tax Court and the Second Circuit held that the active business requirements of section 355 were fully satisfied (A. 269, 289). They rejected the Commissioner's contention that the business of Northwest was acquired from Pacific in a transaction in which gain was recog-

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[17]Cohen, Silverman, Surrey, Tarleau and Warren, The Internal Revenue Code of 1954: Corporate Distributions, Organizations, and Reorganizations, 68 Harv.L.Rev. (1954-1955) 393, 430; Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders, 469 (2d Ed. 1966); *W. E. Gabriel Fabrication Co.* (1964) 42 T.C. 545, 557, acquiescence, C.B. 1965-1, 4.

nized and, therefore, violated the requirements of section 355(b)(2)(C). The Ninth Circuit did not consider this contention, since it had already rejected the application of section 355 on other grounds. The Second Circuit and the Tax Court, however, gave full consideration to the Commissioner's theory and found no difficulty in rejecting it in the light of the language of the statute and its clear legislative purpose. The Second Circuit stated (A. 289):

> "The second danger was that instead of creating a new business, the corporation would purchase one which had been in existence for over five years and then distribute its stock in place of a dividend. To safeguard against this possibility, subsections (b)(2)(C) and (D) prohibit acquisition of a trade or business, or of a corporation, in a transaction in which gain or loss was recognized. In our case no new business, no new assets and no new corporation was acquired at all. No liquid assets were temporarily invested nor, in fact, was there any temporary investment. Consequently, the application of these sections to the instant transaction would serve no purpose at all."

The Commissioner conceded that there was no taxable gain on the transaction to be included in the consolidated return filed by American and its subsidiaries, including Pacific and Northwest. The Commissioner's argument was that while the gain was properly "eliminated," it was nevertheless "recognized." The Tax Court gave this argument short shrift (A. 267):

> "We think that this distinction is spurious, and that the terms 'elimination' and 'nonrecognition' are intended to be synonymous in this context. Apart from the absence of any solid basis for the claimed

distinction, a careful textual examination of the statute and regulations discloses that the word 'eliminated' was used in the sense of 'nonrecognition.' "

As the Tax Court pointed out, the Commissioner's contention that gain on the transfer to Northwest was "recognized" is unsound. Throughout the Code, "recognition" and "nonrecognition" are terms which simply denote that a specified gain or loss shall or shall not be taken into account in computing income. There is no dispute that the transfer of assets to Northwest by Pacific in return for the Northwest stock, the assumption of certain liabilities and the Northwest note did not result in any taxable income. There are three insurmountable obstacles to the Commissioner's contention:

First, he must show that section 355(b)(2)(C) applies to transfers to a controlled corporation of a trade or business already owned by the parent distributing corporation and not acquired from third parties. The Second Circuit held that the prohibition in section 355 applied only to the bringing of new assets within the combined corporate shells of the distributing and controlled corporations, and that it was irrelevant as to internal adjustments of corporate assets through intercorporate transfers (A. 289).

Second, the Commissioner would have to establish that nonrecognition of gain under the consolidated return provisions (which are clearly applicable here) does not involve nonrecognition of gain or loss within the meaning of section 355(b)(2)(C). On this the Tax Court was plainly correct in its holding that there is no basis for a distinction between elimination of gain in a consolidated return and nonrecognition of gain for purposes of section

355 (A. 267). The Tax Court properly held that any gain eliminated from taxability is not recognized gain.

Third, the Commissioner would have to establish that the Northwest note was not a security. While the Tax Court and the Second Circuit found it unnecessary to decide this point (A. 266), the mere fact that the $200,000,000 Northwest note was in form payable on demand in no wise prevents it from qualifying as a security, since it represented a substantial and continuing capital interest in the corporation (*Camp Wolters Enterprises v. Commissioner of Int. Rev.* (5 Cir. 1956) 230 F.2d 555, certiorari denied (1956) 352 U.S. 826). This is evident from the fact that the $200,000,000 indebtedness was refinanced by four issues of 20-year debentures by Northwest in the amounts of $50,000,000 each during the period from 1961 to 1963 (A. 66), and the indebtedness itself originated in the purpose of the plan to provide Northwest with a capital structure having the same proportions of total debt and stock as those of Pacific prior to the transfer (A. 54). It was not feasible for Northwest to assume a prorata part of the long-term debt of Pacific then outstanding, and instead the demand note was given so that Northwest could create its own long-term debt to replace the permanent capital represented by the Northwest note given to Pacific.

On none of his hypertechnical interpretations and applications of the "active business" requirement is the Commissioner correct.

D. The distribution of the Northwest stock through two rights offerings satisfied the requirements of section 355(a)(1)(D).

For the first time before the Courts of Appeals, the Commissioner contended that section 355(a)(1)(D) required that the stock of the controlled corporation be distributed in a single distribution (A. 327). Both circuit courts considered this question of law on its merits and both rejected the Commissioner's contention.

The Second Circuit pointed out that nothing in the statute requires distribution of stock in a single offering. Section 355(a)(1)(D) simply embodies the Congressional decision that only complete and not partial divisions would receive tax-free status (A. 290). The section permits the retention of a limited amount of stock as long as such retention is not pursuant to a plan of Federal income tax avoidance. As the Second Circuit stated (A. 291):

> "[T]here is nothing on the face of this subsection that relates to the number of transactions, or their timing, which may be contained in a distribution. These matters are entirely governed by the more flexible 'device' clause of Section 355(a)(1)(B) which is fully adequate for this purpose and which clearly is no bar to the qualification of this corporate division."

The Commissioner's contention that periodic distributions of stock might be used as a substitute for dividends was considered by the Second Circuit to have no application, since the reorganization involved in the instant cases was a genuine corporate division and could not conceivably be considered to involve a substitute for dividends (A. 292). The court considered the incongruity of limiting section 355 to a single distribution when viewed

against the other provisions of Subchapter C dealing with reorganizations. Pointing to the fact that in 1961 Pacific was the eighth largest nonfinancial company in the United States, with over 38,000 shareholders, it stated that the reorganization involved the distribution of over 30,000,000 shares of Northwest stock and raised for Pacific nearly half a billion dollars. The Second Circuit found that none of the other reorganization sections imposed any requirement of a single distribution, and to impose in this case the requirement suggested by the Commissioner would be staggering (A. 293).

The rule is well established that all of the steps which are an integral part of a plan of reorganization are to be considered as parts of a single transaction. This rule has been stated by this Court in *Helvering v. Alabama Asphaltic Limestone Co.* (1942) 315 U.S. 179, 184-185:

> "Some contention, however, is made that this transaction did not meet the statutory standard because the properties acquired by the new corporation belonged at that time to the committee and not to the old corporation. That is true. Yet, the separate steps were integrated parts of a single scheme. Transitory phases of an arrangement frequently are disregarded under these sections of the revenue acts where they add nothing of substance to the completed affair. *Gregory v. Helvering,* 293 U.S. 465; *Helvering v. Bashford,* 302 U.S. 454. Here they were no more than intermediate procedural devices utilized to enable the new corporation to acquire all the assets of the old one pursuant to a single reorganization plan."

This rule, that all of the integral steps of carrying out a plan of reorganization must be treated as a single trans-

action, applies generally to all types of corporate reorganizations treated in Subchapter C of the Code. Section 355 is part of Subchapter C, and deals with all types of divisive reorganizations. The rule of *Alabama Asphaltic* therefore applies to section 355. The Commissioner, in interpreting section 355, has ruled that the step transaction doctrine, generally applicable to all types of reorganizations, applies to divisive reorganizations under section 355 (Rev.Rul. 57-311, C.B. 1957-2, 243).[18]

Without the step transaction doctrine, section 355 might be completely unworkable when applied to corporations having large numbers of shareholders. Reorganizations may take many forms. Delays in completing reorganizations may be encountered not merely because of the magnitude of the transactions involved and of the complexities of the corporate adjustments, but also because of litigation or necessary action of regulatory agencies. Mere lapse of time between the steps necessary to consummate a plan of reorganization has never been considered a basis for nonapplication of the reorganization provisions. Frequently, tax-free reorganizations are effected over a period of time which overlaps several taxable years.[19] No administrative difficulties have been encountered by the Commissioner in applying the reorganization provisions in this manner. Procedures are

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[18]Cf. *W. E. Gabriel Fabrication Co.* (1964) 42 T.C. 545, 552, acquiescence C.B. 1965-2, 5.

[19]*D. W. Douglas* (1938) 37 B.T.A. 1122, 1128 (5 years between distributions); *Roosevelt Hotel Co.* (1949) 13 T.C. 399, 407 (4 years); *Pearson Hotel, Inc. v. United States* (N.D.Ill. 1959) 199 F.Supp. 33 (15 years); *Preston Wilson* (1961) T.C.Memo.No. 1965-135, 20 T.C.M. 676, 688 (3 years); *Moffatt v. C.I.R.* (9 Cir. 1966) 363 F.2d 262, certiorari denied (1967) 386 U.S. 1016 (over 2 years).

readily available to the Commissioner to protect the revenue in the event the reorganization is not carried out in accordance with the plan of reorganization. By waivers of the statute of limitations or by the assessment of taxes and the filing of claims for refund, taxpayers' returns may be held open for final adjustment until all the steps of the reorganization have been consummated.[20]

In any event, as the Second Circuit pointed out, the enormity of the administrative difficulties may be measured in part by the failure of the Commissioner to raise this single distribution point in the Tax Court (A. 294).[21] The Second Circuit, moreover, pointed out that the Commissioner is not prevented from drafting reasonable regulations designed to ameliorate any administrative problems that might arise from more than one distribution (A. 295).

The Tax Court here properly applied the step transaction doctrine. The Tax Court found as a fact that: "There is no dispute between the parties that the two offerings were component parts of a single plan and that they must be regarded together as resulting in the disposition of 100 percent of the Northwest stock in a single

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[20]The fear expressed by Judge Friendly of the Second Circuit (A. 297-303), that permitting more than one distribution under section 355 would prevent the proper determination of tax liability on the basis of annual accounting periods, is groundless. There is no reason to distinguish in this respect between reorganizations under section 355 and reorganizations under any of the other sections of Subchapter C.

[21]Pacific requested the Commissioner's ruling on behalf of its shareholders in March, 1961. The cases were tried in the Tax Court in December, 1964, and final briefs were filed with the Tax Court in May of 1965.

transaction'' (A. 255, n. 4). This finding is correct and is fully supported by the record.

The plan of reorganization contained in the proxy material (A. 100-112) and the registration statement (A. 117-127) filed with the Securities and Exchange Commission stated unequivocally that all of the Northwest shares would be distributed pursuant to the plan, which it was anticipated would be completed within a period of three years. Pacific's constant needs for new capital (A. 85) gave virtual assurance that the distribution would be completed in the time anticipated. In point of fact, all of the Northwest stock was distributed within less than two years.

The testimony on this point was compelling. Mr. John O. Einerman, the Vice President and Comptroller of Pacific who presented the plan of reorganization to the board of directors and shareholders of Pacific, testified specifically on this matter.[22] The Pacific management was faced with complex and difficult corporate and financial problems in distributing the Northwest stock to the Pacific shareholders. Mr. Einerman testified that the Northwest stock was a new security of unknown market value

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[22] [By Mr. Horrow:] "Mr. Einerman, were the offerings of rights to purchase Northwest common stock in 1961 and 1963 inseparable, one from the other?

* * * * *

"The Court: Let me ask the witness. Would the second step be taken without the first?

"The Witness: No, sir. These two steps were just part of the same plan.

"The Court: And when you took the first step, did you intend to present to the board of directors the taking of the second step?

"The Witness: Absolutely, this was basic to the plan" (A. 196-197; cf. A. 191).

(A. 205). The questions to what extent and over what period of time the Northwest stock could be absorbed by the Pacific shareholders under the rights offerings involved perplexing factual determinations. The total capital paid in to Pacific under the rights offerings was in excess of $480,000,000, over 95 percent of which was provided by the Pacific shareholders. The presentation to the Pacific directors made by Mr. Einerman illustrates the complex factual considerations involved (A. 128-138).

It was for the trier of fact, the Tax Court, to determine whether all of the steps involved in the distribution of the Northwest stock were part of a single transaction. The Ninth Circuit in finding to the contrary (A. 333) invaded the province of the Tax Court as the fact-finding tribunal.

Salutary rules limiting review of findings of fact by the courts of appeals are set forth in *Commissioner v. Duberstein* (1960) 363 U.S. 278. There the Court held that Tax Court findings cannot be rejected unless they are clearly erroneous, and such findings include factual inferences developed from undisputed facts as much as they do other findings of fact. The question whether the several steps involved in the distribution of the Northwest stock were parts of a single transaction is essentially a question of fact, not of law. This Court in *Dobson v. Commissioner* (1943) 320 U.S. 489, 502, said:

> "Whether an apparently integrated transaction shall be broken up into several separate steps and whether what apparently are several steps shall be synthesized into one whole transaction is frequently a necessary determination in deciding tax consequences. Where no statute or regulation controls, the Tax

Court's selection of the course to follow *is no more reviewable than any other question of fact*" (emphasis added).

The Ninth Circuit, as an independent reason for reversing the Tax Court, devised a new rule for the purposes of this case (A. 333):

> "[W]e think that a fair interpretation of section 355 requires that there be a single transaction in which a controlling interest is transferred and that for two or more distributions to be entitled to treatment as a single transaction transferring control of the controlled corporation to the shareholders of the distributing corporation, such distributions must not extend over any greater period of time than is reasonably necessary considering the practical problems involved in completing such distributions * * *."

The Second Circuit aptly commented on this innovation of the Ninth Circuit (A. 295, n. 9):

> "While this approach effectively compromises the harshness of the Commissioner's argument, the statute contains no such requirement."[23]

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[23] As the Second Circuit observed, the step transaction doctrine has been invoked by the Commissioner to defeat tax avoidance, by asserting that a tax-free reorganization occurred (A. 284). Congress was well aware of the possibility of using split-ups and split-offs as methods of using paper losses to establish deductions for tax purposes (H.Rept. 704, 73d Cong., 2d Sess., C.B. 1939-1 (Part 2) 563-564):

> "The subcommittee, and later the committee, made a careful study of the provisions governing exchanges and reorganizations, since it appeared that these sections had frequently been used as a means of tax avoidance. One suggested solution was the complete elimination of the provisions, with the expectation that in the course of time, by means of court decisions and perhaps new legislation, a more desirable method of

In these cases all the stock of Northwest was actually distributed in accordance with the plan of reorganization. At the time the plan was adopted, there was a fixed intention and a commitment on the part of Pacific to distribute all of the Northwest stock to its shareholders. Under these circumstances, the Second Circuit and the Tax Court properly held that the requirements of section 355(a)(1)(D) were fully satisfied.

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treatment could be built up. The Treasury believed such a procedure might result in some immediate loss of revenue, as well as in a severe handicap upon legitimate exchanges and reorganizations. Moreover, reorganizations are now being consummated in the majority of cases in order to reduce the capital structure and quite generally show a loss. In the past, the reverse was true, and reorganizations were carried out to expand the capital structure and generally showed a gain. The committee decided that, under present conditions, the wiser policy is to amend the provisions drastically to stop the known cases of tax avoidance, rather than to eliminate the sections completely. This decision will further avoid the period of litigation and uncertainty which would necessarily follow a complete reversal of the established policy."

If the application of section 355 could be excluded merely by using two distributions, a ready means of tax avoidance would be available.

III

THE SECOND CIRCUIT COURT OF APPEALS PROPERLY HELD IN DOCKET NO. 760 THAT THE SALE OF THE NORTHWEST RIGHTS GAVE RISE TO CAPITAL GAINS RATHER THAN DIVIDEND INCOME.

Taxpayers in No. 760 received 1,540 shares of common stock of Pacific. Since six rights and $16 were required for each share of Northwest, they exercised 1,536 rights, thereby acquiring 256 shares of Northwest stock, and sold the remaining four rights for net proceeds of $6.36 (A. 69). The Tax Court held that the total proceeds of sale represented taxable dividend income (A. 271). The Second Circuit Court of Appeals reversed the Tax Court, holding that the sale of the rights gave rise to a capital gain (A. 296).

The Tax Court's position was based on the fact that section 355 did not apply to the rights which were sold, and that without section 355, the distribution of the Northwest stock would have resulted in a dividend, the anticipation of which by sale resulted similarly in a dividend (A. 271). It is true that section 355 does not apply to the sale of the rights. However, as the Second Circuit pointed out (A. 296), section 355 is a statutory device for determining that a distribution of capital rather than of earnings and profits has occurred. The Northwest stock represented the equity of the Pacific shareholders in approximately 20 per cent of the business and assets of Pacific. The stock rights issued represented the Pacific shareholders' right to preserve that equity. To the extent that the taxpayers exercised their rights, they preserved their equity. To the extent that they sold their rights,

they realized on a portion of their equity. Had the taxpayers sold either their Pacific stock or the Northwest stock to which they would have been entitled on the exercise of the rights, they clearly would have realized capital gains. The taxpayers should be in no different position than they would have been in had they sold the Northwest stock itself in anticipation of the exercise of their rights. The stock rights must be equated with the Northwest stock to which they relate.

Gibson v. Commissioner of Internal Revenue (2 Cir. 1943) 133 F.2d 308 held that the proceeds of sale of rights which, upon exercise, would have given rise to dividend income, represented an anticipatory realization of that dividend income (*Helvering v. Horst* (1940) 311 U.S. 112). Applying the *Gibson* principle to this case, the Northwest stock to which the rights related was, by reason of section 355, a capital distribution, rather than a dividend distribution out of the earnings and profits of Pacific or Northwest (cf. *Miles v. Safe Deposit Co.* (1922) 259 U.S. 247). The sale of this capital interest in the form of rights is a capital transaction and should be so treated.

The treatment under section 1234(a) is analogous. Under that section, a gain on the sale of an option is treated as ordinary or capital, depending upon whether a gain from the sale of the property subject to the option would be ordinary or capital. Here it is clear that a gain on the sale of the Northwest stock, the property subject to the option (the stock rights), would be a capital gain. Similarly, gain on the sale of the stock rights, as the Second Circuit correctly held, should be treated as a capital gain.

CONCLUSION

The judgment of the Court of Appeals for the Second Circuit in No. 760 should be affirmed, and the judgment for the Court of Appeals for the Ninth Circuit in No. 781 should be reversed with directions to affirm the Tax Court.

Respectfully submitted,

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(Appendix Follows)

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Appendix

Internal Revenue Code of 1954:

SEC. 301. DISTRIBUTIONS OF PROPERTY.

(a) IN GENERAL.—Except as otherwise provided in this chapter, a distribution of property (as defined in section 317 (a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

(b) AMOUNT DISTRIBUTED.—

(1) GENERAL RULE.—For purposes of this section, the amount of any distribution shall be—

(A) NONCORPORATE DISTRIBUTEES.—If the shareholder is not a corporation, the amount of money received, plus the fair market value of the other property received.

(B) CORPORATE DISTRIBUTEES.—If the shareholder is a corporation, the amount of money received, plus whichever of the following is the lesser:

(i) the fair market value of the other property received; or

(ii) the adjusted basis (in the hands of the distributing corporation immediately before the distribution) of the other property received, increased in the amount of gain to the distributing corporation which is recognized under subsection (b) or (c) of section 311, under section 341(f), or under section 1245(a) or 1250(a).

(C) CERTAIN CORPORATE DISTRIBUTEES OF FOREIGN CORPORATION.—Notwithstanding subparagraph (B), if the shareholder is a corporation and the distributing corporation is a foreign corporation, the amount taken into account with respect to property (other than money) shall be the fair market value of such property; except that if any deduction is allowable under section 245 with respect to such distribution, then the amount taken into account shall be the sum (determined under regulations prescribed by the Secretary or his delegate) of—

(i) the proportion of the adjusted basis of such property (or, if lower, its fair market value) properly attributable to gross income from sources within the United States, and

(ii) the proportion of the fair market value of such property properly attributable to gross income from sources without the United States.

(2) REDUCTION FOR LIABILITIES.—The amount of any distribution determined under paragraph (1) shall be reduced (but not below zero) by—

(A) the amount of any liability of the corporation assumed by the shareholder in connection with the distribution, and

(B) the amount of any liability to which the property received by the shareholder is subject immediately before, and immediately after, the distribution.

(3) DETERMINATION OF FAIR MARKET VALUE.—For purposes of this section, fair market value shall be determined as of the date of the distribution.

(c) AMOUNT TAXABLE.—In the case of a distribution to which subsection (a) applies—

(1) AMOUNT CONSTITUTING DIVIDEND.—That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.

(2) AMOUNT APPLIED AGAINST BASIS.—That portion of the distribution which is not a dividend shall be applied against and reduce the adjusted basis of the stock.

(3) AMOUNT IN EXCESS OF BASIS.—

(A) IN GENERAL.—Except as provided in subparagraph (B), that portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock, shall be treated as gain from the sale or exchange of property.

(B) DISTRIBUTIONS OUT OF INCREASE IN VALUE ACCRUED BEFORE MARCH 1, 1913.—That portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock and to the extent that it is out of increase in value accrued before March 1, 1913, shall be exempt from tax.

* * * * *

SEC. 351. TRANSFER TO CORPORATION CONTROLLED BY TRANSFEROR.

(a) GENERAL RULE.—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange

such person or persons are in control (as defined in section 368 (c)) of the corporation. For purposes of this section, stock or securities issued for services shall not be considered as issued in return for property.

(b) Receipt of Property.—If subsection (a) would apply to an exchange but for the fact that there is received, in addition to the stock or securities permitted to be received under subsection (a), other property or money, then—

(1) gain (if any) to such recipient shall be recognized, but not in excess of—

(A) the amount of money received, plus

(B) the fair market value of such other property received; and

(2) no loss to such recipient shall be recognized.

(c) Special Rule.—In determining control, for purposes of this section, the fact that any corporate transferor distributes part or all of the stock which it receives in the exchange to its shareholders shall not be taken into account.

* * * * *

SEC. 354. EXCHANGES OF STOCK AND SECURITIES IN CERTAIN REORGANIZATIONS.

(a) General Rule.—

(1) In General.—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securi-

ties in such corporation or in another corporation a party to the reorganization.

(2) LIMITATION.—Paragraph (1) shall not apply if—

(A) the principal amount of any such securities received exceeds the principal amount of any such securities surrendered, or

(B) any such securities are received and no such securities are surrendered.

(3) CROSS REFERENCE.—

For treatment of the exchange if any property is received which is not permitted to be received under this subsection (including an excess principal amount of securities received over securities surrendered), see section 356.

* * * * *

SEC. 355. DISTRIBUTION OF STOCK AND SECURITIES OF A CONTROLLED CORPORATION.

(a) EFFECT ON DISTRIBUTEES.—

(1) GENERAL RULE.—If—

(A) a corporation (referred to in this section as the "distributing corporation")—

(i) distributes to a shareholder, with respect to its stock, or

(ii) distributes to a security holder, in exchange for its securities, solely stock or securities of a corporation (referred to in this section as "controlled corporation") which it controls immediately before the distribution,

(B) the transaction was not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both (but the mere fact that subsequent to the distribution stock or securities in one or more of such corporations are sold or exchanged by all or some of the distributees (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device),

(C) the requirements of subsection (b) (relating to active businesses) are satisfied, and

(D) as part of the distribution, the distributing corporation distributes—

(i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or

(ii) an amount of stock in the controlled corporation constituting control within the meaning of section 368 (c), and it is established to the satisfaction of the Secretary or his delegate that the retention by the distributing corporation of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax,

then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder or security holder on the receipt of such stock or securities.

(2) NON PRO RATA DISTRIBUTIONS, ETC.—Paragraph (1) shall be applied without regard to the following:

(A) whether or not the distribution is pro rata with respect to all of the shareholders of the distributing corporation,

(B) whether or not the shareholder surrenders stock in the distributing corporation, and

(C) whether or not the distribution is in pursuance of a plan of reorganization (within the meaning of section 368 (a) (1) (D)).

(3) LIMITATION.—Paragraph (1) shall not apply if—

(A) the principal amount of the securities in the controlled corporation which are received exceeds the principal amount of the securities which are surrendered in connection with such distribution, or

(B) securities in the controlled corporation are received and no securities are surrendered in connection with such distribution.

For purposes of this section (other than paragraph (1) (D) of this subsection) and so much of section 356 as relates to this section, stock of a controlled corporation acquired by the distributing corporation by reason of any transaction which occurs within 5 years of the distribution of such stock and in which gain or loss was recognized in whole or in part, shall not be treated as stock of such controlled corporation, but as other property.

(4) Cross reference.—

For treatment of the distribution if any property is received which is not permitted to be received under this subsection (including an excess principal amount of securities received over securities surrendered), see section 356.

(b) Requirements as to Active Business.—

(1) In general.—Subsection (a) shall apply only if either—

(A) the distributing corporation, and the controlled corporation (or, if stock of more than one controlled corporation is distributed, each of such corporations), is engaged immediately after the distribution in the active conduct of a trade or business, or

(B) immediately before the distribution, the distributing corporation had no assets other than stock or securities in the controlled corporations and each of the controlled corporations is engaged immediately after the distribution in the active conduct of a trade or business.

(2) Definition.—For purposes of paragraph (1), a corporation shall be treated as engaged in the active conduct of a trade or business if and only if—

(A) it is engaged in the active conduct of a trade or business, or substantially all of its assets consist of stock and securities of a corporation controlled by it (immediately after the distribution) which is so engaged,

(B) such trade or business has been actively conducted throughout the 5-year period ending on the date of the distribution,

(C) such trade or business was not acquired within the period described in subparagraph (B) in a transaction in which gain or loss was recognized in whole or in part, and

(D) control of a corporation which (at the time of acquisition of control) was conducting such trade or business—

(i) was not acquired directly (or through one or more corporations) by another corporation within the period described in subparagraph (B), or

(ii) was so acquired by another corporation within such period, but such control was so acquired only by reason of transactions in which gain or loss was not recognized in whole or in part, or only by reason of such transactions combined with acquisitions before the beginning of such period.

SEC. 356. RECEIPT OF ADDITIONAL CONSIDERATION.

(a) GAIN ON EXCHANGES.—

(1) RECOGNITION OF GAIN.—If—

(A) section 354 or 355 would apply to an exchange but for the fact that

(B) the property received in the exchange consists not only of property permitted by section 354

or 355 to be received without the recognition of gain but also of other property or money,

then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(2) Treatment as dividend.—If an exchange is described in paragraph (1) but has the effect of the distribution of a dividend, then there shall be treated as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be treated as gain from the exchange of property.

(b) Additional Consideration Received in Certain Distributions.—If—

(1) section 355 would apply to a distribution but for the fact that

(2) the property received in the distribution consists not only of property permitted by section 355 to be received without the recognition of gain, but also of other property or money,

then an amount equal to the sum of such money and the fair market value of such other property shall be treated as a distribution of property to which section 301 applies.

(c) Loss.—If—

(1) section 354 would apply to an exchange, or section 355 would apply to an exchange or distribution, but for the fact that

(2) the property received in the exchange or distribution consists not only of property permitted by section 354 or 355 to be received without the recognition of gain or loss, but also of other property or money,

then no loss from the exchange or distribution shall be recognized.

(d) Securities as Other Property.—For purposes of this section—

(1) In general.—Except as provided in paragraph (2), the term "other property" includes securities.

(2) Exceptions.—

(A) Securities with respect to which nonrecognition of gain would be permitted.—The term "other property" does not include securities to the extent that, under section 354 or 355, such securities would be permitted to be received without the recognition of gain.

(B) Greater principal amount in section 354 exchange.—If—

(i) in an exchange described in section 354 (other than subsection (c) thereof), securities of a corporation a party to the reorganization are surrendered and securities of any corporation a party to the reorganization are received, and

(ii) the principal amount of such securities received exceeds the principal amount of such securities surrendered,

then, with respect to such securities received, the term "other property" means only the fair market value of such excess. For purposes of this subparagraph and subparagraph (C), if no securities are surrendered, the excess shall be the entire principal amount of the securities received.

(C) GREATER PRINCIPAL AMOUNT IN SECTION 355 TRANSACTION.—If, in an exchange or distribution described in section 355, the principal amount of the securities in the controlled corporation which are received exceeds the principal amount of the securities in the distributing corporation which are surrendered, then, with respect to such securities received, the term "other property" means only the fair market value of such excess.

(e) EXCHANGES FOR SECTION 306 STOCK.—Notwithstanding any other provision of this section, to the extent that any of the other property (or money) is received in exchange for section 306 stock, an amount equal to the fair market value of such other property (or the amount of such money) shall be treated as a distribution of property to which section 301 applies.

(f) TRANSACTIONS INVOLVING GIFT OR COMPENSATION.—For special rules for a transaction described in section 354, 355, or this section, but which—

(1) results in a gift, see section 2501 and following, or

(2) has the effect of the payment of compensation, see section 61(a)(1).

Income Tax Regulations:

Sec. 1.301-1. Rules applicable with respect to distributions of money and other property.

* * * * *

(j) *Transfers for less than fair market value.* If property is transferred by a corporation to a shareholder which is not a corporation for an amount less than its fair market value in a sale or exchange, such shareholder shall be treated as having received a distribution to which section 301 applies. In such case, the amount of the distribution shall be the difference between the amount paid for the property and its fair market value. If property is transferred in a sale or exchange by a corporation to a shareholder which is a corporation, for an amount less than its fair market value and also less than its adjusted basis, such shareholder shall be treated as having received a distribution to which section 301 applies, and—

(1) Where the fair market value of the property equals or exceeds its adjusted basis in the hands of the distributing corporation the amount of the distribution shall be the excess of the adjusted basis over the amount paid for the property;

(2) Where the fair market value of the property is less than its adjusted basis in the hands of the distributing corporation, the amount of the distribution shall be the excess of such fair market value over the amount paid for the property.

If property is transferred in a sale or exchange after December 31, 1962, by a foreign corporation to a shareholder which is a corporation for an amount less than the

amount which would have been computed under paragraph (n) of this section if such property had been received in a distribution to which section 301 applied, such shareholder shall be treated as having received a distribution to which section 301 applies, and the amount of the distribution shall be the excess of the amount which would have been computed under paragraph (n) of this section with respect to such property over the amount paid for the property. In all cases, the earnings and profits of the distributing corporation shall be decreased by the excess of the basis of the property in the hands of the distributing corporation over the amount received therefor. In computing gain or loss from the subsequent sale of such property, its basis shall be the amount paid for the property increased by the amount of the distribution.

(k) *Application of rule respecting transfers for less than fair market value.* The application of paragraph (j) of this section may be illustrated by the following examples:

Example (1). On January 1, 1955, A, an individual shareholder of Corporation X, purchased property from that corporation for $20. The fair market value of such property was $100, and its basis in the hands of Corporation X was $25. The amount of the distribution determined under section 301(b) is $80. If A were a corporation, the amount of the distribution would be $5, the excess of the basis of the property in the hands of Corporation X over the amount received therefor. The basis of such property to Corporation A would be $25. If the basis of the property in the hands of Corporation X were

$10, the corporate shareholder, A, would not receive a distribution. The basis of such property to Corporation A would be $20. Whether or not A is a corporation, the excess of the amount paid over the basis of the property in the hands of Corporation X ($20 over $10) would be a taxable gain to Corporation X.

Example (2). On January 1, 1963, corporation A, which is a shareholder of corporation B (a foreign corporation engaged in business within the United States), purchased one share of corporation X stock from B for $20. The fair market value of the share was $100, and its adjusted basis in the hands of B was $25. Assume that if the share of corporation X stock had been received by A in a distribution to which section 301 applied, the amount of the distribution under paragraph (n) of this section would have been $55. The amount of the distribution under section 301 is $35, i.e., $55 (amount computed under paragraph (n) of this section) minus $20 (amount paid for the property). The basis of such property to A is $55.

* * * * *

Sec. 1.351-1. Transfer to corporation controlled by transferor.

(a)(1) Section 351(a) provides, in general, for the nonrecognition of gain or loss upon the transfer by one or more persons of property to a corporation solely in exchange for stock or securities in such corporation, if immediately after the exchange, such person or persons are in control of the corporation to which the property was transferred. As used in section 351, the phrase "one or more persons" includes individuals, trusts, estates, partnerships, associations, companies, or corporations (see

section 7701(a)(1)). To be in control of the transferee corporation, such person or persons must own immediately after the transfer stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of such corporation (see section 368(c)). In determining control under this section, the fact that any corporate transferor distributes part or all of the stock which it receives in the exchange to its shareholders shall not be taken into account. The phrase "immediately after the exchange" does not necessarily require simultaneous exchanges by two or more persons, but comprehends a situation where the rights of the parties have been previously defined and the execution of the agreement proceeds with an expedition consistent with orderly procedure. For purposes of this section—

(i) stock or securities issued for services rendered or to be rendered to or for the benefit of the issuing corporation will not be treated as having been issued in return for property, and

(ii) stock or securities issued for property which is of relatively small value in comparison to the value of the stock and securities already owned (or to be received for services) by the person who transferred such property, shall not be treated as having been issued in return for property if the primary purpose of the transfer is to qualify under this section the exchanges of property by other persons transferring property. For the purpose of section 351, stock rights or stock warrants are not included in the term "stock or securities."

(2) The application of section 351(a) is illustrated by the following examples:

Example (1). C owns a patent right worth $25,000 and D owns a manufacturing plant worth $75,000. C and D organize the R Corporation with an authorized capital stock of $100,000. C transfers his patent right to the R Corporation for $25,000 of its stock and D transfers his plant to the new corporation for $75,000 of its stock. No gain or loss to C or D is recognized.

Example (2). B owns certain real estate which cost him $50,000 in 1930, but which has a fair market value of $200,000 in 1955. He transfers the property to the N Corporation in 1955 for 78 percent of each class of stock of the corporation having a fair market value of $200,000, the remaining 22 percent of the stock of the corporation having been issued by the corporation in 1940 to other persons for cash. B realized a taxable gain of $150,000 on this transaction.

Example (3). E, an individual, owns property with a basis of $10,000 but which has a fair market value of $18,000. E also had rendered services valued at $2,000 to Corporation F. Corporation F has outstanding 100 shares of common stock all of which are held by G. Corporation F issues 400 shares of its common stock (having a fair market value of $20,000) to E in exchange for his property worth $18,000 and in compensation for the services he has rendered worth $2,000. Since immediately after the transaction, E owns 80 percent of the outstanding stock of Corporation F, no gain is recognized upon the exchange of the property for the stock. However, E realized $2,000

of ordinary income as compensation for services rendered to Corporation F.

(b)(1) Where property is transferred to a corporation by two or more persons in exchange for stock or securities, as described in paragraph (a) of this section, it is not required that the stock and securities received by each be substantially in proportion to his interest in the property immediately prior to the transfer. However, where the stock and securities received are received in disproportion to such interest, the entire transaction will be given tax effect in accordance with its true nature, and in appropriate cases the transaction may be treated as if the stock and securities had first been received in proportion and then some of such stock and securities had been used to make gifts (section 2501 and following), to pay compensation (section 61(a)(1)), or to satisfy obligations of the transferor of any kind.

(2) The application of paragraph (b)(1) of this section may be illustrated as follows:

Example (1). Individuals A and B, father and son, organize a corporation with 100 shares of common stock to which A transfers property worth $8,000 in exchange for 20 shares of stock, and B transfers property worth $2,000 in exchange for 80 shares of stock. No gain or loss will be recognized under section 351. However, if it is determined that A in fact made a gift to B, such gift will be subject to tax under section 2501 and following. Similarly, if B had rendered services to A (such services having no relation to the assets transferred or to the business of the corporation) and the disproportion in the amount of stock

received constituted the payment of compensation by A to B, B will be taxable upon the fair market value of the 60 shares of stock received as compensation for services rendered, and A will realize gain or loss upon the difference between the basis to him of the 60 shares and their fair market value at the time of the exchange.

Example (2). Individuals C and D each transferred, to a newly organized corporation, property having a fair market value of $4,500 in exchange for the issuance by the corporation of 45 shares of its capital stock to each transferor. At the same time, the corporation issued to E, an individual, 10 shares of its capital stock in payment for organizational and promotional services rendered by E for the benefit of the corporation. E transferred no property to the corporation. C and D were under no obligation to pay for E's services. No gain or loss is recognized to C or D. E received compensation taxable as ordinary income to the extent of the fair market value of the 10 shares of stock received by him.

Sec. 1.351-2. Receipt of property.

(a) If an exchange would be within the provisions of section 351(a) if it were not for the fact that the property received in exchange consists not only of property permitted by such subsection to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property. No loss to the recipient shall be recognized.

(b) See section 357 and the regulations pertaining to that section for applicable rules as to the treatment of liabilities as "other property" in cases subject to section 351, where another party to the exchange assumes a liability, or acquires property subject to a liability.

(c) See sections 358 and 362 and the regulations pertaining to those sections for applicable rules with respect to the determination of the basis of stock, securities, or other property received in exchanges subject to section 351.

(d) See Part I (section 301 and following), subchapter C, chapter 1 of the Code, and the regulations thereunder for applicable rules with respect to the taxation of dividends where a distribution by a corporation of its stock or securities in connection with an exchange subject to section 351(a) has the effect of the distribution of a taxable dividend.

* * * * *

Sec. 1.355-1. Distribution of stock and securities of controlled corporation.

(a) *Application of section.* Section 355 provides for the separation, without recognition of gain or loss to the shareholders and security holders, of two or more existing businesses formerly operated, directly or indirectly, by a single corporation. It applies only to the separation of existing businesses which have been in active operation for at least five years, and which, in general, have been owned for at least five years by the corporation making the distribution of stock or of stock and securities. Section 355 does not apply to the division of a single business.

For the purpose of section 355, stock rights or stock warrants are not included in the term 'stock and securities'.

(b) *Types of separations.* Section 355 is concerned with two general types of separations of businesses. The first is the distribution of the stock of an existing corporation. The second is the distribution of the stock of a new corporation which stock was received in exchange for the assets of a business previously operated by the distributing corporation. In both cases, this section contemplates the continued operation of the businesses existing prior to the separation.

* * * * *

Sec. 1.355-2. Limitations.

(a) *Property distributed.* The property distributed must consist solely of stock or stock and securities of a controlled corporation. If additional property (including an excess principal amount of securities received over securities surrendered) is received, see section 356.

(b) *Distribution of earnings and profits.* (1) The transaction must not have been used principally as a device for the distribution of the earnings and profits of the distributing corporation or of the controlled corporation or of both. If, pursuant to an arrangement negotiated or agreed upon prior to the distribution of stock or securities of the controlled corporation, part or all of the stock or securities of either corporation are sold or exchanged after the distribution, such sale or exchange will be evidence that the transaction was used principally as a device for the distribution of the earnings and profits of the distributing corporation or of the controlled corpo-

ration, or both. However, if the rules respecting continuity of interest contained in paragraph (c) of this section are not met, section 355 will not apply. If a sale of such stock or securities is made after the distribution and is not pursuant to an arrangement negotiated or agreed upon prior to the distribution, the mere fact of such sale is not determinative that the transaction was used principally as a device for the distribution of earnings and profits, but such fact will be evidence that the transaction was used principally as such a device.

(2) A sale is pursuant to an arrangement agreed upon prior to the distribution when enforcible rights to buy or to sell exist before such distribution. In any case in which a sale or exchange was discussed by the buyer and the seller before the distribution, but enforcible rights to buy or to sell did not exist before such distribution, the question whether an arrangement was negotiated within the meaning of section 355(a)(1)(B) shall be determined from all the facts and circumstances.

(3) In determining whether a transaction was used principally as a device for the distribution of the earnings and profits of the distributing corporation or of the controlled corporation or both, consideration will be given to all of the facts and circumstances of the transaction. In particular, consideration will be given to the nature, kind and amount of the assets of both corporations (and corporations controlled by them) immediately after the transaction. The fact that at the time of the transaction substantially all of the assets of each of the corporations involved are and have been used in the active conduct of trades or businesses which meet the requirements of sec-

tion 355(b) will be considered evidence that the transaction was not used principally as such a device.

(c) *Business purpose.* The distribution by a corporation of stock or securities of a controlled corporation to its shareholders with respect to its own stock or to its security holders in exchange for its own securities will not qualify under section 355 where carried out for purposes not germane to the business of the corporations. The principal reason for this requirement is to limit the application of section 355 to certain specified distributions or exchanges with respect to the stock or securities of controlled corporations incident to such readjustment of corporate structures as is required by business exigencies and which, in general, effect only a readjustment of continuing interests in property under modified corporate forms. Section 355 contemplates a continuity of the entire business enterprise under modified corporate forms and a continuity of interest in all or part of such business enterprise on the part of those persons who, directly or indirectly, were the owners of the enterprise prior to the distribution or exchange. All the requisites of business and corporate purposes described under § 1.368 must be met to exempt a transaction from the recognition of gain or loss under this section.

(d) *Stock and securities distributed.* The distributing corporation must distribute—

(1) All of the stock and securities of the controlled corporation which it owns, or

(2) At least an amount of the stock which constitutes control as defined in section 368(c). In such

case all, or any part, of the securities of the controlled corporation may be distributed.

Where a part of either the stock or securities is retained under (2), it must be established to the satisfaction of the Commissioner that such retention was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax. Ordinarily, the business reasons (as distinguished from the desire to make a distribution of the earnings and profits) which support a distribution of stock and securities of a controlled corporation under paragraph (c) of this section will require the distribution of all of the stock and securities. If the distribution of all of the stock and securities of a controlled corporation would be treated to any extent as a distribution of 'other property' under section 356, this fact does not tend to establish that the retention of any of such stock and securities is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax.

(e) *Principal amount of securities.* (1) Section 355(a)(1) is not applicable if the principal amount of securities received exceeds the principal amount of securities surrendered or if securities are received and no securities are surrendered. In such cases, see section 356.

(2) If only stock is received in a transaction to which section 355 is applicable, the principal amount of securities surrendered, if any, and the par or stated value of stock is not relevant to the application of such section. For example: All of the stock of Corporation A is owned by X, an individual, and securities in the principal amount

of $100,000 which were issued by Corporation A are owned by Y, an individual. Corporation A distributes all of the stock of a controlled corporation to Y in exchange for his securities. The par or stated value of the stock of the controlled corporation is $150,000. No gain or loss is recognized to Y upon the receipt of the stock of the controlled corporation.

(f) *Period of ownership.* (1) For the purposes of determining whether gain or loss will be recognized upon a distribution, stock of a controlled corporation acquired (in a transaction in which gain or loss is recognized, in whole or in part) within five years of the date of the distribution of such stock is treated as 'other property'. Section 355 does not apply to a transaction which includes a distribution of such stock. See section 356. The stock so acquired is 'stock', however, for the purpose of the requirements respecting the distribution of stock of such controlled corporation provided in section 355(a)(1)(D).

(2) Paragraph (f)(1) of this section may be illustrated by the following example:

Example. Corporation A has held 85 of the 100 outstanding shares of the stock of Corporation B for more than five years on the date of distribution. Six months before such date, it purchased 10 shares of such stock. If all of the stock of the controlled corporation owned by Corporation A is distributed, section 355 is not applicable to such distribution since the 10 shares would represent 'other property.' See, however, section 356. If, however, for proper business reasons it is decided to retain some of the stock of Corporation B, then the determination of

the amount of such stock which must be distributed under section 355(a)(1)(D) in order to constitute a distribution to which section 355 is applicable must be made by reference to all of the stock of the controlled corporation including the 10 shares acquired six months before such date and the 5 shares owned by others. Similarly, if, by the use of any agency, the distributing corporation acquires stock of the controlled corporation within five years of the date of distribution, for example, where another subsidiary purchases such stock, such stock will be treated as 'other property.' If Corporation A had held only 75 of the 100 outstanding shares of stock of Corporation B for more than five years on the date of distribution and had purchased the remaining 25 shares six months before such date, neither section 355 nor section 356 would be applicable.

(G) *Active businesses.* The rules of section 355(b) and § 1.355-4, relating to active businesses, must be satisfied.

* * * * *

Sec. 1.1502-31. Bases of tax computation.

* * * * *

(b) *Computations.* In the case of affiliated corporations which make, or are required to make, a consolidated return, and except as otherwise provided in the regulations under section 1502:

(1) *Taxable income.* The taxable income of each corporation shall be computed in accordance with the provisions covering the determination of taxable income of separate corporations, except:

(i) There shall be eliminated unrealized profits and losses in transactions between members of the affiliated group and dividend distributions from one member of the group to another member of the group (referred to in the regulations under section 1502 as intercompany transactions);

* * * * *

(A separately bound record appendix contains additional portions of the record on review beyond those printed in Appendix B to petitioner's brief).

Nos. 760 and 781

In the Supreme Court of the United States

October Term, 1967

Commissioner of Internal Revenue, petitioner

v.

Irving Gordon and Margaret Gordon

Oscar E. Baan and Evelyn K. Baan, petitioners

v.

Commissioner of Internal Revenue

ON WRITS OF CERTIORARI TO THE UNITED STATES COURTS OF APPEALS FOR THE SECOND AND NINTH CIRCUITS

REPLY BRIEF FOR THE COMMISSIONER

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In the Supreme Court of the United States

OCTOBER TERM, 1967

No. 760

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

IRVING GORDON AND MARGARET GORDON

No. 781

OSCAR E. BAAN AND EVELYN K. BAAN, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRITS OF CERTIORARI TO THE UNITED STATES COURTS OF APPEALS FOR THE SECOND AND NINTH CIRCUITS

REPLY BRIEF FOR THE COMMISSIONER

I. THE DETAILED REQUIREMENTS OF SECTION 355 MUST BE APPLIED WITH PRECISION TO EFFECT THE CONGRESSIONAL PURPOSE OF INSURING AGAINST UNINTENDED USES OF DIVISIVE REORGANIZATIONS

Taxpayers' principal contention seems to be that, whatever the statute may say, Pacific's 1961 disposition of 57 percent of the Northwest stock should be ruled tax-free because "the result * * * was a spin-

off reorganization which Congress intended to be tax-free under Section 355" (Br. 29),[1] and Congress (Br. 34) "intended that the widest latitude be permitted in the forms and methods used in carrying out" divisive reorganizations. But, despite the taxpayers' broad sweep, this case turns on the detailed language of Section 355, which provides exceptional tax treatment for "a carefully and elaborately defined category of transactions", cf. *Braunstein* v. *Commissioner*, 374 U.S. 65, 71. As a comparison of Section 355 with the prior 1951 law shows, the 1954 provision is one of the "less liberal rules" that the 1954 Congress adopted "in order *to insure* that transactions which are in substance, although not in form, dividend distributions * * * are subject to tax at ordinary income rather than at capital gain rates * * *." S. Rep. No. 1622, 83d Cong., 2d Sess., p. 42 (emphasis supplied); see, also, H. Rep. No. 1337, 83d Cong., 2d Sess., p. 34. The present law must be interpreted and applied in a manner consistent with this general statement of congressional purpose.

Thus, it is not enough for the taxpayers to say that the transaction here was not one "used principally as a device for the distribution of earnings and profits * * *." See Section 355(a)(1)(B). There is more to the statute than this. It is concerned with means as well as ends. The detailed requirements that Section 355 imposes on the process of distribution, the continuation of businesses, and the amount of the stock distributed constitute the means Congress pre-

[1] "Br." refers to taxpayers' opening brief in this Court.

scribed to limit the use of the spin-off. Each is more restrictive than the 1951 law,[2] and plainly designed "to insure," S. Rep. No. 1622, *supra,* p. 42, against unintended uses of corporate divisions.

The provisions of the statute on which we rely, Sections 355 (a)(1)(A) and 355(a)(1)(D), are detailed and specific. The less objective test of Section 355(a)(1)(B) is a supplementary safeguard, which excludes from tax-free treatment any transaction that comes within the letter of the other parts of Section 355, but nevertheless "principally" constitutes a tax-avoidance device.[3] Compare *Gregory* v. *Helvering,* 293 U.S. 465. A proper view of Section 355, then, means that Pacific's disposition of Northwest's stock must comply with the specific provisions of the statute. We turn to a further examination of the statute, and such contentions as taxpayers address to the language of Sections 355(a)(1)(A) and 355(a)(1)(D).[4]

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[2] In Section 355(a)(1)(A), the phrase "with respect to its stock" replaced the more flexible clause "in pursuance of a plan of reorganization," see Section 355(a)(2)(C) of the 1954 Code and Section 112(b)(11) of the 1939 Code, and the word "solely" was added before "stock or securities." The requirement of Section 355(a)(1)(D) that at least 80 percent control be distributed eliminated the provision of the 1951 law, Section 112(g)(1)(D) of the 1939 Code, that allowed the post-spin-off control of the subsidiary to be shared by "both" the parent and its shareholders, a change that the 1954 Code did not apply to nondivisive reorganizations, see Sections 368(a)(1)(D) and 354(b)(1)(B). Compare Regs. § 39.112(b)(11)2(C) under the 1939 Code, which said that "*ordinarily* * * * all of the stock" of the subsidiary will be distributed. (Emphasis supplied.)

[3] The same analysis applies to taxpayers' reliance (Br. 36, 63) on the language of Section 355(a)(1)(D)(ii).

[4] Taxpayers in No. 760 concede (Br. 71) "that section 355 does not apply to the sale of the rights." They nevertheless

II. TAXPAYERS HAVE FAILED TO SHOW THAT PACIFIC'S TRANSACTION SATISFIES SECTION 355(a)(1)(A)

1. As we explain in detail in our opening brief, at pages 23–40, Pacific's sale of the Northwest stock for a substantial cash consideration to those holding rights could not be the distribution "to a shareholder, with respect to its stock" required by Section 355(a)(1)(A). In response, taxpayers ask (Br. 25, 36–37, 47–49), in essence, how the transaction can fail to qualify for tax-free treatment when it would have fallen within Section 355(a)(1)(A) if Pacific's shareholders had received all of the Northwest stock free of cash consideration, and had therefore received a greater value.

There is neither a paradox nor an anomaly in the fact that a greater distribution may be allowed more favorable tax treatment than a lesser one would receive, all other things being equal. For example, Section 346(a)(2) and 346(b) permit taxation at the more favorable capital-gains level for substantial distributions which represent a partial liquidation, *i.e.*, "a genuine contraction of the business" (S. Rep. No. 1622, 83d Cong., 2d Sess., p. 262; see, also, Treas. Reg.

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maintain (Br. 71–72) that they should be taxed on the sale of rights as if it were a sale of stock received tax-free under Section 355, pointing, for analogy, to Section 1234(a), which provides that gain "attributable to the sale" of an option shall have the same character as gain on the sale of property to which the option relates. The answer to this contention is seen in *Gibson* v. *Commissioner*, 133 F. 2d 308 (C.A. 2), where rights with a value of $12,255 at the date of issuance were sold for $13,728.04. The sales proceeds, to the extent of the original value of the rights, were treated as dividend income and the additional $1,473.04 as capital gain attributable to the sale of the rights.

Section 1.346-1(a)), although a lesser distribution would generally be taxable at ordinary rates as a dividend.

Section 355 is an analogue of the partial liquidation provisions. It is addressed to, in the Second Circuit's words (R. 290), "only complete, and not partial divisions" of a corporation. It requires the same sort of contraction, or "break-up" (S. Rep. No. 781, 82d Cong., 1st Sess., p. 58), of the original corporate enterprise as a partial liquidation. The principal distinction—and the one that justifies tax-free treatment under Section 355—is that "solely stock or securities" rather than property is "distributed." See our opening brief at pages 35–37. Thus, just as occurs when a distribution is too small to qualify for capital treatment under Section 346, ordinary income rates should be applied here. Since the money Pacific received substantially replaced the assets sold [5] and Pacific parted with only 57 percent of the Northwest stock in 1961, the necessary division and contraction were lacking.[6]

[5] The book value of the Northwest stock in Pacific's hands was less than $16 per share, since it reported a gain on the sale. (R. 248.) Consequently, after exercise of the rights, Pacific's books showed greater assets than when it held the Northwest stock. This too shows that there was not a contraction of the Pacific enterprise.

[6] Taxpayers claim that difficulties under State law were the principal motivation underlying the cash consideration. The theory is that the diminution of the capital structure of Pacific resulting from a distribution of Northwest stock without consideration would have been of questionable propriety under California law (R. 240).

This means, however, on taxpayers' own approach to the case, that State law barred the required contraction; there is of course no justification for relaxing a federal tax statute to

2. When they do turn (Br. 52) to the language of Section 355 (a)(1)(A), taxpayers rely (Br. 52–58) on the statement in *Palmer* v. *Commissioner,* 302 U.S. 63, 69, that "a sale of corporate assets to stockholders is, in a literal sense, a distribution of its property". They argue that it is "self-contradictory" for the Ninth Circuit and the Commissioner to find a distribution "with respect to stock" for purposes of the dividend provision of Section 301 and still hold there is no distribution with respect to stock for purposes of Section 355.

In their analysis, taxpayers have chosen to ignore the other half of the sentence in *Palmer* to which they refer. The unmentioned words are: "such a transaction does not necessarily fall within the statutory definition of a dividend." 302 U.S. at 69. And this language is the heart of the matter. As *Palmer* holds, there is no dividend—*i.e.,* no "distribution * * * with respect to * * * stock" under Section 301—if corporate property is sold to shareholders at fair market value.

There is such a "distribution * * * with respect to * * * stock" only when the sale is a "bargain"—the price is less than value. In that circumstance, which is

provide relief from federal tax consequences flowing from the State scheme of regulation.

(State law was never thought a complete barrier to a spin-off, and the Tax Court was not wholly persuaded that these difficulties were real obstacles (R. 240). The record repeatedly shows, moreover, that the overriding purpose of the cash consideration was to finance substantial past and projected expansion of the California operation (R. 239–240, 49, 87–93, 108–109, 128–132).)

the present case, the item "distributed" is the value of the "bargain," measured by the spread between the price and value.[7] Rights representing the bargain—as were distributed in this case—are clearly a "distribution of *property*" (emphasis supplied) that Sections 301 and 316 make taxable as a dividend. The rights are just as obviously not "solely stock," which is what may be distributed tax-free under Section 355. "The situation is the same as if [Pacific] had sold the [Northwest stock] to strangers [at $26] and then distributed to its stockholders an amount of cash equal to that 'spread.' " *Choate* v. *Commissioner,* 129 F. 2d 684, 687 (C.A. 2). This conclusion is amply supported by authorities, such as *Helvering* v. *Southwest Corp.,* 315 U.S. 194, *Commissioner* v. *LoBue,* 351 U.S. 243, and Section 317(a) of the 1954 Code, which we analyze at pages 23–29 and 46–49 of our opening brief.[8]

[7] There is nothing to the contrary, as taxpayers suggest (Br. 56, n. 15), in the Commissioner's ruling here that "No taxable income will result * * * by reason of holding the * * * rights" and that "The receipt * * * of stock of * * * Northwest * * * upon the exercise of the * * * rights * * * will result in a distribution of property under section 301". These are the results of a computational convenience, see our opening brief at page 49, based on the premise that, as happened here, there would be no material change in the value of Northwest stock between the issuance and sale or exercise of the rights. The Commissioner's position is that there is capital gain or loss, on the sale of the rights in the amount of any such variance. See *Gibson* v. *Commissioner, supra.*

[8] The effect on Pacific's earnings and profits would not, as taxpayers maintain (Br. 47), be an anomaly. That effect usually flows by statute when a distribution of corporate property is a dividend under Sections 301 and 316, as it is unless it qualifies for

3. Taxpayers do not deny that Pacific "sold" the Northwest stock; they contend (Br. 55), however, that the word "distributes" as used in Section 355 includes such a "sale." Their argument seems to be that the word "exchange" is used at one point to describe a "distribution" under Section 355(a)(1)(A), that a "sale" is an "exchange," and therefore that "distribution" includes "sale."

The "exchange" in Section 355 is limited, however, in a way that excludes cash. Section 355(a)(1)(A)(ii), which deals with a spin-off to security holders, requires that "solely stock or securities" of the subsidiary be "distributed" "in exchange for * * * securities" of the parent. These last words would not have been used unless Congress had contemplated that in the exchange the security holder would give up only "securities" of the parent—and not cash or any other item.[9]

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exceptional treatment under Section 355 or some other part of the Code. The same "anomaly" would exist if Pacific had purchased, and then distributed, General Motors shares to its shareholders, even though both Pacific's and General Motor's earnings would remain in corporate solution.

As to taxpayers' apparent suggestion (Br. 46-47) of an improper effect on the basis of the Pacific stock in the hands of those who received rights, see our opening brief at p. 34, n. 11.

[9] The use of the word "exchange" reflects the requirement of Section 355 that such a security holder report gain on a spin-off unless he surrenders securities of the parent in a principal amount equal to or greater than those of the subsidiary which he receives. See our opening brief at page 23, n. 9. If the statute contemplated an "exchange" for cash, Section 355(a)(4) would require the addition of the amount of that cash to the principal amount of the surrendered securities, and the total would be deducted from the principal amount of the securities received in measuring the security-holders' gain.

Taxpayers also say that the use of the word "surrenders" in Section 355(a)(2)(B) shows that "exchanges" and "sales" are generally within Section 355(a)(1)(A). Again the statutory words show a quite different meaning. The surrender is only of "stock" of the parent. This is intended to accommodate the redemptions that mark split-ups and split-offs. This is entirely in keeping with the usual use of the word "surrender" in the Internal Revenue Code—to deal with the circumstance where the shareholder gives his corporation its own stock—and nothing more—upon a distribution of corporate property.

4. Taxpayers never expressly discuss the requirement of Section 355(a)(1)(A) that the parent distribute "to a shareholder" stock in the subsidiary. They seem to allude to it, however, when they assert (Br. 31) that the "purpose was fulfilled" because "Over 95 per cent of the Northwest stock went to the Pacific shareholders, including taxpayers, through the exercise of the rights issued to them." Here, again, taxpayers cannot justify their failure to satisfy the specific statutory language because, in their view, they *almost* achieved the result that the statute demands.

Taxpayers' statistic, moreover, glosses over what really happened. The 95 percent figure resulted only because A.T. & T. received and exercised nearly 90 percent of the rights. Of the minority, over one-third failed to acquire the Northwest stock for which they received the rights (R. 141). This latter number is the proper measure of what is likely to happen when a corporation without a dominant shareholder follows

the same procedure Pacific used here. Such a case must have the same tax consequences as the present one, yet it plainly would not involve the method or results that Congress, in Section 355(a)(1)(A), required of a tax-free spin-off.

5. Nor may it even be said, as taxpayers contend (Br. 43), that Pacific's transaction presented "nothing * * * resembling any bail-out of earnings", by which we assume they mean a dividend distribution (see Br. 30). Each Pacific Shareholder had the option to sell or to exercise his rights.[10] Those who sold received cash. The right sold was an opportunity to share in the part of Pacific's earned surplus that had been transferred to Northwest (see R. 98). Each recipient of the rights had the opportunity to realize cash on his rights, and that cash was directly traceable to part of Pacific's earnings. Thus every shareholder was able to—and a third of the minority in fact did—obtain cash in exchange for giving someone else the right to buy Northwest stock from Pacific. This more than "resembled" a dividend.

[10] Taxpayers urge (Br. 50–51) that the transferability of the stock rights is insignificant because Congress in Section 355(a)(1)(B) indicated its intention not to prevent the alienation of property. But the provision of Section 355(a)(1)(B) states only that sales of the distributing or controlled corporation's stock or securities are to be disregarded, unless made pursuant to a "prior" "arrangement." This hardly means that Congress wanted to encourage sales through a distribution of transferable rights. The use of transferable rights, the sale of which Pacific wished to facilitate (R. 120–121), instead suggests there was here the very sort of "arrangement" Section 355(a)(1)(B) was designed to bar.

III. PACIFIC'S TWO SEPARATE DISTRIBUTIONS CANNOT BE BROUGHT WITHIN SECTION 355(a)(1)(D) BY USE OF THE "STEP TRANSACTION" DOCTRINE

Although Pacific sold only 57% of the Northwest stock in 1961, the taxpayers contend that the requirements of Section 355(a)(1)(D) were met because Pacific sold the rest of the stock in 1963. Section 355(a)(1)(D)(i) requires that "all of the stock" held by the distributing corporation "immediately before the distribution" must be distributed. The only exception is that under Section 355(a)(1)(D)(ii) the requirement is met in certain cases where at least 80 percent of the stock is distributed.

Neither the Commissioner nor the courts could apply Section 355 with reasonable certainty if the statutory requirement for a single distribution were construed so expansively as to encompass the widely separated offerings of the instant case. We do not contend that everything must be done in one instant, or on one day. We do contend that the step transaction doctrine on which taxpayers rely (Br. 63–70) could be invoked to fuse the two Pacific offerings only if the entire distribution were obligated from the outset, and only if the two steps were mutually interdependent so that one would be ineffective without the other. Neither of these prerequisites is fulfilled here.[11]

[11] The Ninth Circuit, in holding that the offerings of Northwest stock were not a single transaction, did not invade the fact-finding province of the Tax Court. There is only the legal question whether the undisputed facts accord with what Section 355 demands. *Dobson* v. *Commissioner*, 320 U.S. 489, 502, on which taxpayers rely (Br. 68) applied to situations "[w]here no statute or regulation controls * * *."

1. Taxpayers seem to recognize that there should have been a commitment to distribute all of the stock (or at least 80 per cent of it) to the Pacific shareholders, but the record does not support their assertion that "there was a fixed intention and a commitment on the part of Pacific to distribute all of the Northwest stock to its shareholders." (Br. 70.) At no point, until the second distribution was made, did the Pacific shareholders have any enforceable rights to the rest of the stock. Examination of the papers used shows that Pacific's management carefully refrained from committing itself.

In the proxy statement asking shareholders to approve the formation of Northwest, Pacific included the "Plan for Reorganization," which stated (R. 108): "Promptly after acquiring the securities of [Northwest] * * * [Pacific] will offer for sale" approximately 56% of the Northwest stock through the issuance of rights. As to further distributions, the statement was that "It is *expected* that within *about* three years" the balance of the stock would be offered "for sale" in "*one or more* offerings." (R. 109; emphasis supplied.) The prices were to "be determined by the Board [of Pacific] at the time of each offering." It was further stated that "It is *expected* that in each case the offering price will be in excess of the par value of the * * * stock." (R. 109; emphasis supplied.)

This "plan," obviously drafted by skilled counsel, left all the choices with Pacific and no legal right to additional shares with its shareholders. No shareholder could compel the sale of any amount of stock, at any time, or at any price. All these matters were left, as

both the Second and Ninth Circuits agreed (R. 281, 330), to the "sole discretion" of Pacific's directors. The only conceivable constraint was "the capital requirements of Pacific" (R. 281), a matter that in itself could be determined only by the discretionary business judgment of the directors.

As Judge Friendly pointed out in his dissent (R. 299–300), a variety of contingencies "might have postponed Pacific's need for funds and consequent further distribution of Northwest stock for many years." See, also, the Ninth Circuit opinion at R. 329. There was no way of determining as of September 1961—or at any other time before April 1963 (see R. 251)—when future offerings of Northwest stock would be made, or at what price.[12]

It was not even necessary that the stock be offered to Pacific's shareholders. All that the plan said was that "it is expected" that such an offering would be made. This was no doubt an accurate statement, but it was not a binding commitment, and deliberately so. No shareholder would have had a right to complain if Pacific had thereafter decided to sell the remaining Northwest stock to the public—or sold part of it and distributed the remainder. Pacific clearly had the right, if its directors so chose, to follow a policy of "indefinite retention" of more than 20 percent of the Northwest stock. Taxpayers in No. 760 acknowledged below (see R. 292) that such a result would prohibit tax-free treatment, which is obviously correct.

[12] "The Ninth Circuit view (and the dissent in *Gordon*) seems to be the more acceptable interpretation of this provision." Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders* (2d ed., 1968 Supplement No. 1) 35.

2. Even if there had been a commitment in 1961 that Pacific would "within three years" distribute the remaining stock to its shareholders, the step transaction theory would still be unavailable because the 1961 transaction had distinct and sought-after business purposes, which were achieved in that year without regard to what happened thereafter. See *American Bantam Car Co.* v. *Commissioner,* 11 T.C. 397, 405–407, affirmed *per curiam,* 177 F. 2d 513 (C.A. 3). It is clear that each distribution depended on the set of facts existing when it was made. Pacific had a number of objectives. It wanted to decentralize, and it did, in 1961. It sought to give A.T. & T. voting control, and the 1961 offering achieved that result. Pacific needed money—so much and no more; the 1961 rights were exercised so as to meet that need with precision.

What would be done thereafter depended on the facts as they later developed. Pacific did not want future sales prescribed in advance. It wanted to maintain flexibility and freedom in making further offerings, according to its needs as they appeared. No case has applied the step transaction doctrine in such a situation. Nor should the step transaction theory be used except in furtherance of the underlying objectives of the statute. Pacific's 1961 distribution achieved its own purposes, but without the "complete separation" of subsidiary from parent which is the whole basis of Section 355's operation. Since Section 355(a)(1)(D) requires the distribution of "all of the stock" held by the parent "immediately before the distribution", there must be a time when the separation can be fixed. The use of the word "immediately"

suggests that the duration of this period must be relatively short. This case does not call for a final determination of what flexibility is allowed in effecting the distribution.[13] Here the parent had no obligation to act in any definite way at any definite time, and in fact retained the unsold stock for 21 months. Any retention of this sort, without commitment, should take the transaction beyond the ambit of Section 355.[14]

3. Although not expressly acknowledged, the "step transaction" doctrine is an essential premise of tax-

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[13] Taxpayers suggest that it is unreasonable to require that the events of one day be used to measure compliance with Section 355(a)(1)(D). Although they and the Second Circuit call the consequences "staggering" (Br. 64, R. 293), they nowhere explain why it would be any more difficult than the usual corporate practice of paying dividends to those who are shareholders at the close of business on a given day. The statute requires no more than a distribution to shareholders of record as of a given date, for such a distribution would be aimed at a particular and fixed shareholder group. It would make no difference precisely when each shareholder actually received the stock, because his rights would have been defined by the declaration; and it would be permissible for the physical process of distribution to occur "with an expedition consistent with orderly procedure." Cf. Treas. Reg., Section 1.351-1(a)(1). See, also, the Ninth Circuit opinion at R. 333. Here, of course, the evidence shows that Pacific's extended retention of Northwest stock bore no relationship to difficulties encountered in the process of distribution.

[14] Rev. Rul. 57-311, 1957-2 Cum. Bull. 243, does not (see Br. 65) suggest that there may be a split distribution of stock. The focus was on the payment of cash to a shareholder who then paid the amount over to a newly formed corporate subsidiary, all of whose stock he received. The shareholder was merely a conduit for and received no benefit from the money. Here, in contrast, Pacific retained the Northwest stock, and all the resulting benefits, such as dividends, for a substantial period of time.

payers' argument, and the Second Circuit's conclusion, that Pacific's transaction complied with Section 355(a)(1)(A), for rights can be viewed as a distribution of "solely stock" of Northwest only if their issuance and exercise are regarded as merely "Transitory phases" that "add nothing of substance to the completed affair." *Helvering* v. *Alabama Asphaltic Limestone Co.,* 315 U.S. 179, 184–185. But this approach was urged and rejected in *Southwest Consolidated Corp., supra,* a case that was argued and decided at the same time as *Alabama Asphaltic Limestone.* In holding that the transaction did not qualify as a reorganization because the use of warrants meant that there was not the use of "solely voting stock", the Court explained (315 U.S. at 201):

> And it makes no difference that, in the long run, the unexercised warrants expired and nothing but voting stock was outstanding. The critical time is the date of the exchange. * * *

The "critical time" under Section 355(a)(1)(A) is the date of the "distribution". The only event of that day here was the distribution of warrants, evidencing rights to buy Northwest stock. It makes no more difference here than in *Southwest* that once the rights were exercised or expired, only the Northwest stock was outstanding. "'Solely' leave no leeway." *Id.* at 198. When Pacific chose to distribute rights, and sell the stock, it went outside the tax-free route of Section 355.

CONCLUSION

The judgment of the Second Circuit should be reversed and the judgment of the Ninth Circuit should be affirmed.

Respectfully submitted.

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MARCH 1968.

U.S. GOVERNMENT PRINTING OFFICE: 1968

Supreme Court of the United States

October Term, 1967

Nos. 760 and 781

Commissioner of Internal Revenue,
Petitioner,
vs.
Irving Gordon and Margaret Gordon,
Respondents.
No. 760

On Writ of Certiorari to the United States Court of Appeals for the Second Circuit

Oscar E. Baan and Evelyn M. Baan,
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REPLY BRIEF OF RESPONDENTS IN NO. 760 AND OF PETITIONERS IN NO. 781

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On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

REPLY BRIEF OF RESPONDENTS IN NO. 760 AND OF PETITIONERS IN NO. 781

This brief is filed on behalf of the respondents in No. 760 and the petitioners in No. 781 ("taxpayers"), in reply to the brief filed February 29, 1968, for the peti-

tioner in No. 760 and for the respondent in No. 781 ("Commissioner").[1]

QUESTIONS PRESENTED

The principal question presented by these cases relates to the application of section 355. The Commissioner has not framed the question in his brief, however, so as to reflect properly the opposing views of the parties and to apprise the Court of the real issues in these cases. There is *no issue,* as suggested by the Commissioner, whether the distribution of *rights* qualified for nonrecognition of gain under section 355 (Com. Br. 2, 15). Such a contention has never been made on behalf of taxpayers, nor has any of the courts below so held. The Commissioner's statement of the question is lacking also (Com. Br. 2, 16) in that it ignores a question which *was* presented and decided in the three courts below, whether the distribution of *all* the Northwest stock by two rights offerings under a single plan of divisive reorganization qualifies for nonrecognition under section 355.

The Commissioner determined the deficiencies involved in these cases in accordance with his rulings of June 28, 1961, and November 15, 1962 (A. 152-153, 158-159).[2] The Commissioner determined that the receipt of the Northwest *stock,* not the receipt of the *rights,* was taxable in-

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[1]References to the Commissioner's brief will appear hereinafter as "Com. Br." References to the taxpayers' opening brief will appear hereinafter as "Taxp. Br."

[2]The pertinent rulings are quoted and briefly analyzed in taxpayers' opening brief, page 56, footnote.

come upon the exercise of the rights by the taxpayers, measured by the difference between the value of the Northwest stock at the date of exercise and the offering price. Strangely, nowhere in his brief before this Court has the Commissioner seen fit to contend that his original determination was correct. He now contends that the subject of the distributions which are taxable is the Northwest rights. Nowhere does he advise the Court *how*, under his new theory, these rights should be taxed where they are exercised. The Commissioner limits his discussion of the manner of taxing rights under his theory to the situation where rights are *sold*. He states that:

> "Analytically, the rights should be considered dividend income on the date distributed. * * *
>
> "Although this is the technical analysis of the situation, it is convenient in these cases, where rights are sold, to minimize the amount of computation involved, and to treat the proceeds on sale as being the dividend, rather than the fair market value on the date of the receipt of the rights" (Com. Br. 49).

While espousing this novel rule of "convenience" where rights are sold, the Commissioner fails to deal with other essential questions involved in the tax treatment of stock rights which are inherent in and flow from his underlying theory.

How does the "convenience" rule apply where rights are exercised? Where rights have a market value, does taxability of such rights depend on whether there is a so-called "spread" between the offering price and the value of the stock at the time the rights are issued? Where rights are exercised, is the amount of income the value of the rights at the time of receipt; the value of the rights

at the time of exercise; or the "spread" at the date of exercise? Where rights lapse, is income received at the time the rights are issued, and a loss sustained when the rights lapse? In the case of corporate shareholders receiving and exercising rights, are such rights *not* dividend income on the ground that the rights had no basis in the hands of the issuing corporation?

The Commissioner's improper statement of the issue raises questions on the tax treatment of rights which he signally fails even to mention.

THE COMMISSIONER'S STATEMENTS OF FACT

The Commissioner's brief is so replete with inaccurate statements of fact, misrepresentations of the record and misleading and improper inferences and speculations not supported by the record as to present a seriously distorted picture of the actual facts. The facts of these cases are the facts found by the Tax Court. They are properly summarized in the statement of the case set forth in the taxpayers' brief (Taxp. Br. 4-23). The Commissioner took no exception to the findings of fact by the Tax Court during the course of these proceedings.

Prominent among these distortions are the Commissioner's statements that Pacific chose not to distribute the Northwest stock directly to the Pacific shareholders without consideration "for its own reasons," and "[i]t did not suit Pacific's purposes to distribute the stock to its own shareholders without consideration, for it wanted to use the stock as a means of raising the funds to pay off

the advances from A. T. & T. and to raise additional capital for use in its California operations" (Com. Br. 38). Similar statements are made suggesting that Pacific could have chosen to distribute the Northwest stock without consideration but instead chose to use stock rights offerings in order to raise capital (Com. Br. 4, 6, 37). The record is clear that the reason why Pacific decided to use rights offerings and require a cash consideration was that Pacific had been advised by its counsel that it could *not* lawfully, under the California corporation law,[3] distribute the stock directly to Pacific's shareholders without payment of consideration by them. After such method was discarded as the means of distributing the Northwest stock to its stockholders, Pacific turned to rights offerings and, since this method involved the inflow of capital, adapted the method of distribution to its capital requirements.[4] To suggest that Pacific adopted the rights-offering method for the direct purpose of raising capital, rather than for its real and primary purpose of the distribution of the Northwest stock in conformity with the California corporation law, is false.

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[3]Mr. Einerman, the Vice President and Comptroller of Pacific, testified (A. 199):

> "A. Mr. Holt, as I stated, we considered many plans, and the plan that you mention of distributing the shares in the form of a stock dividend was one of the plans that was considered, and we had to eliminate that one immediately, because we were advised by counsel that it was illegal to do this.
>
> "Therefore we didn't pay any more attention to that particular plan. We went ahead to develop a plan that we could use."

[4]Normally, Pacific's method of raising new capital was the issuance of Pacific's own stock and debentures (A. 47). These methods, of course, were still available to meet its needs for capital in 1961.

After erroneously stating that Pacific could have distributed the Northwest stock to the Pacific shareholders without consideration, as noted above, the Commissioner makes another misleading statement: "Pacific could also have sold the Northwest stock at market value, a course it recognized as 'the normal tendency' (R. 91), in which case its shareholders would have received no gain in the transaction" (Com. Br. 38). The record is devoid of any evidence that Pacific could have carried out its plan of distributing the Northwest stock to its shareholders by offering the Northwest stock to them "at market value." The fact is that the offering price was fixed at approximately 40 per cent below market value in order to induce the Pacific shareholders to exercise their rights and achieve as wide a distribution of its stock to its shareholders as possible.[5]

In similar vein is the Commissioner's statement at pages 3 to 4 that a distinct objective which Pacific "wished to satisfy through such a division [of Pacific's business]" was to generate enough cash to liquidate a substantial portion of Pacific's accumulated indebtedness to American. On the contrary, the decision to divide Pacific into two separate corporations with separate stock ownership had nothing to do with the liquidation of American's advances.[6] That decision was based on studies

[5] In presenting the plan of reorganization to the Pacific directors, Mr. Einerman stated:

"A lower price would produce higher rights values and should result in a broader distribution of the stock among our shareholders" (A. 91).

[6] The stipulation shows clearly that obtaining advances from American was the normal method of temporary financing used by Pacific. Permanent security financing was substituted when these advances had grown large enough to warrant it (A. 37).

conducted over a period of more than two years, which concluded that the division would be extremely desirable from an operating point of view (A. 235-236). The operating and management advantages sought to be achieved by the separation are set out in the Tax Court's findings. Any implication that the satisfaction of the indebtedness to American was a motivating factor of the divisive reorganization is untrue.[7]

The Commissioner makes a serious misrepresentation of Pacific's commitment to offer *all* of the Northwest stock to its shareholders under the plan. The Commissioner states, "Pacific thus was under no obligation to offer the remainder of the Northwest stock at any point in time" (Com. Br. 40-41). At page 13 and again at page 16, the Commissioner does not even bother to qualify the statement by reference to a point in time; he says (p. 16), "where the remaining 43 percent was disposed of * * * in

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[7]The statement (Com. Br. 38) that, but for the filing of a consolidated return, American might have realized a taxable gain of $150,000,000 from the exercise of the Northwest rights, is false and misleading. Apparently it is designed to suggest a callous disregard on the part of Pacific of the tax position of its shareholders other than American. The fact is that American's tax position had nothing to do with the consolidated return. Under the Commissioner's own rulings, not applying section 355, the amount of any distribution by Pacific to American and *all other corporate shareholders* of Pacific, was the excess of the *basis* of the Northwest stock in the hands of Pacific over the offering price (sec. 301(b)(1)(B)). Since the basis of such stock was less than $16 a share, neither American nor any other corporate shareholders of Pacific was deemed to have received a dividend (A. 123). This was the result whether or not American filed a consolidated return.

Equally misleading is the Commissioner's mention of Pacific's receipt of an unfavorable ruling with respect to the individual shareholders (Com. Br. 8, 38), and his failure to mention that Pacific had immediately sought reconsideration of this ruling, which was not forthcoming until November 15, 1962 (A. 71, 155).

a transaction which *was in no way obligated* at the time the first offering was made. Can an offering of 57 percent of stock, *with no further obligation,* constitute disposition of 'control' * * *" (emphasis added).

The facts are that the plan provided:

> "The Pacific Company *shall* offer to its shareholders as set forth below the right to purchase *all* of the shares of capital stock of the New Company acquired pursuant to this Plan" (emphasis added; A. 238).

The plan provided that after the first offering in 1961 (A. 103-104):

> "At a time or times related to its need for new capital, the Company *will* offer the remainder of the shares of the New Company for sale in a similar manner to shareholders of the Company" (emphasis added).

The prospectus accompanying the first rights offering stated "the balance of the 30,460,000 shares * * * *will* be offered for sale later" (A. 117—emphasis added); and "later" was defined as "*within* about three years * * * at times related to its need for new capital" (A. 125—emphasis added).[8] The registration and proxy statements containing these commitments were filed with the Securities and Exchange Commission, thereby exposing Pacific

[8]By avoiding mention of these statements from the plan and prospectus and pointing instead to a single selected statement out of the entire context: "It is expected that within about three years after acquiring the stock of the New Company, the Company by one or more offerings will offer for sale the balance of such stock, * * *" (A. 109), the Commissioner misrepresents Pacific's commitment. The words "it is expected" obviously referred to the maximum period within which the distribution would be completed, rather than to any indefiniteness of the obligation itself.

to civil and criminal liabilities if any material misrepresentations were made.

There was virtual assurance that Pacific's demands for new capital would require that the remainder of the Northwest stock be offered within three years. Pacific's capital needs could be predicted with a high degree of certainty.[9] In point of fact, all of the Northwest stock was distributed by Pacific within less than two years after the first offering (A. 61-62).

Another serious distortion occurs in the Commissioner's explanation of the $16 offering price for the Northwest stock. The Commissioner explains the offering price almost entirely on the basis of providing shareholders with rights offerings that they would consider additional dividends (Com. Br. 7, 38). The findings conclusively establish that the offering price was based on a consideration of seven different factors, each given equal weight, three affecting Pacific, and four affecting the Pacific shareholders (A. 249-250). Mr. Einerman, who presented the plan to the Pacific board of directors, stated that there was no intention to recommend that a dividend be distributed through the rights offerings (A. 190). The whole tenor of the Commissioner's presentation is that the Northwest

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[9]Pacific's rate of growth, which was expected to continue, is illustrated by the fact that the operations of Pacific in California alone in 1960, in terms of plant investment and operating revenues, exceeded those of the entire company in California, Oregon, Washington and Idaho in 1957 (A. 46). In the seven 12-month periods prior to June 30, 1960, Pacific, by the issuance of common stock or long-term debentures (A. 240), had raised new capital totaling $1,313,000,000 and averaging approximately $187,000,000 per year; for the last five of those years, the average was $225,000,000 (A. 85).

stock was simply an asset which was disposed of by Pacific as "part of an elaborate refinancing operation" (Com. Br. 21; 38-39). On the contrary, Pacific's plan was conceived and carried out as a divisive reorganization,[10] and basic to the plan was the distribution of the Northwest stock to Pacific shareholders. A price was established reflecting all seven factors, which would result in as wide a distribution of the stock as possible among the Pacific shareholders (A. 91). The success of the offerings may best be gauged by the fact that more than 95 per cent of the rights issued to the Pacific shareholders were exercised by them (A. 62, 141).

I

THE COMMISSIONER'S POSITION IN GENERAL

The Commissioner's arguments are predicated on isolating the steps in carrying out Pacific's plan of reorganization and persistently refusing to regard these steps as integral parts of a single, unified plan of reorganization.

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[10]Mr. Einerman testified on cross examination as follows (A. 225-226):

> "Q. Wouldn't you conclude, though, that since Pacific, as far as the offering of the Northwest stock through rights was concerned, was merely selling some of its assets at a profit or a figure over book, and so long as the fair market value of the assets they were selling was received by the corporation, then no distribution of any property took place to the common stockholder and the preferred could not legitimately have any complaint?
>
> "A. Well, I can't agree with that because, as I mentioned this morning, basically, this entire transaction was part of a plan of reorganization. We were not selling an asset of the company just as such. The whole transaction was geared to this plan of reorganization."

With equal persistence he attributes to the plan a primary motive of raising capital, and disregards its true genesis and objective of effecting a divisive reorganization of Pacific's business. The evidence and the Tax Court's findings are clearly contrary to his position.

The Tax Court found: "As a result of the studies [looking toward the division of Pacific into two or three separate companies] Pacific was divided into two separate divisions in 1960 and was then divided into two separate corporations in 1961. * * * The reasons given for dividing the operations of Pacific were the size of the area served by the company * * * the rapid growth of the population * * * and the expected continued growth of the population of the area with a continuing increase in the amount of telephone service required" (A. 236). The Tax Court concluded, "This case concededly involves a spin-off. Pacific plainly divested itself of the business which it had conducted in the three northwest states" (A. 262). There can be no doubt on this record that what Pacific planned and what it in fact accomplished pursuant to the plan was the division of Pacific's business into two corporate entities, each for practical purposes being owned by the same shareholders.

In focusing upon single steps viewed out of the context of the plan as a whole, the Commissioner disregards not only the findings of the Tax Court, but the terms of the plan itself, the proved intention with which it was conceived and carried out, the result which it achieved, and the exposure to penalties had Pacific not carried it out as represented to its shareholders.

As the Second Circuit recognized, where it has served his purpose the Commissioner has not hesitated to argue that separate steps should be disregarded and a reorganization recognized for tax purposes (*Moffatt v. C.I.R.* (9 Cir. 1966) 363 F.2d 262, certiorari denied (1967) 386 U.S. 1016). This has been on the principle that the substance of transactions controls the tax result.

Throughout his brief, the Commissioner has based arguments on the assumption that the 1961 and 1963 offerings of Northwest stock should be separately viewed and treated. This is directly contrary to the finding of the Tax Court that these two stock offerings were component parts of a single plan and must be regarded together as resulting in the distribution of 100 per cent of the Northwest stock in a single transaction (A. 255, n. 4). The Commissioner's view of the stock rights apart from the distribution of the stock and the consummation of the plan of reorganization is equally unsupported. That the rights were the necessary mechanism to effect the distribution of the Northwest stock to the Pacific shareholders is thoroughly established by the record.

In thus dismembering Pacific's integrated reorganization plan, the Commissioner violates a cardinal rule of interpretation and tax treatment of plans of reorganization. This is the rule pronounced by this Court in *Helvering v. Alabama Asphaltic Limestone Co.* (1942) 315 U.S. 179, 184-185:

> "Yet, the separate steps were integrated parts of a single scheme. Transitory phases of an arrangement frequently are disregarded under these sections of the revenue acts where they add nothing of substance

to the completed affair. *Gregory v. Helvering,* 293 U.S. 465; *Helvering v. Bashford,* 302 U.S. 454. Here they were no more than intermediate procedural devices utilized to enable the new corporation to acquire all the assets of the old one pursuant to a single reorganization plan."

Not only has the Commissioner distorted the purpose and intent of the plan, but he has failed to supply any credible, rational basis for imputing income to taxpayers by reason of the exercise of their rights. When taxpayers exercised their rights, they owned no more than they had owned before, as shareholders of Pacific alone. Instead of having only certificates evidencing their ownership of an equity in Pacific, they had two pieces of paper evidencing their same proportionate ownership of an equity in Northwest and Pacific. And far from receiving any benefit which might be characterized as income, they were out-of-pocket, having paid cash into Pacific.

Both the Tax Court and the Second Circuit found it inconceivable that Congress could have intended that no tax should result if the Northwest stock had been distributed to taxpayers without consideration, but that a tax should result, as contended by the Commissioner, when they had paid out money (A. 262, 285). Nowhere does the Commissioner's brief attempt to explain, justify or supply any rational basis for imputing such an intent to Congress. The Commissioner does not in his brief provide any logical or common-sense answer to the question so properly asked by the Second Circuit (A. 277): "how this corporate change of asset ownership brought income to them and, if so, where is it?"

II

THE COMMISSIONER IS IN ERROR IN CONTENDING THAT THE DISTRIBUTION OF THE NORTHWEST STOCK WAS NOT PART OF A BONA FIDE SPIN-OFF WHICH FULFILLED THE CONGRESSIONAL PURPOSES OF SECTION 355.

As our opening brief demonstrates (Taxp.Br. 29-51), Pacific's plan of reorganization achieved the results and fulfilled the Congressional purposes contemplated by section 355.

These purposes are conceded by the Commissioner (Com.Br. 18-20) in words that strikingly fit the transaction at bar:

> "The Senate Finance Committee, in recommending the legislation, commented, '[I]t is economically unsound to impede spin-offs which break-up businesses into a greater number of enterprises, when undertaken for legitimate business purposes.' * * *
>
> * * * * *
>
> "That [legislative] objective was to facilitate the breaking down of the size of corporate undertakings, * * *. The spin-off which Congress had in mind, and to which the language of the statute is clearly directed, is the breaking up of a business into two or more separate entities, with the consequence that the size of the original corporate enterprise is contracted by the genuine separation of its businesses into distinct entities. The shareholders continue to own both, having now more pieces of paper to represent their aggregate ownership than they had before."

This was exactly what was accomplished here. The business formerly conducted by a single corporation—Pacific—in the four states, was broken up into two cor-

porations, with Pacific continuing the business in California, and Northwest continuing the business in the three northwest states. There was a genuine separation of the businesses into the two distinct corporations. There were clearly legitimate business purposes, as the Commissioner concedes (Com.Br. 20). Pacific's original enterprise was contracted to the California operation, while the business in the three northwest states went entirely to Northwest. Pacific's shareholders for all practical purposes continued to own both corporations.

The Commissioner's argument that the transaction at bar falls outside the basic objective of section 355, in simple terms comes down to two points (Com.Br. 20-21):

(1) That there was no spin-off, no breakup of a business, no contraction of the business, all because the business in question was that of American, so that the transaction was a mere rearrangement of American's business rather than a reorganization of Pacific. On the contrary, the stipulations and findings of fact (A. 35, 38, 229, 231) establish beyond question that the business divided and reorganized was that of Pacific[11] before the reorganization, and that of Pacific and Northwest separately after the reorganization. Nothing in either the words or the legislative history of section 355 even remotely supports the Commissioner's conjecture that Congress "perhaps" might have denied tax-free treatment in case of a spin-off of a subsidiary of a subsidiary to the ultimate parent (cf. Rev.Rul. 62-138, C.B. 1962-2, 95);

[11]The Commissioner's brief (pp. 3, 4, and 7) also contains positive assertions that the business was that of Pacific.

and the Commissioner admits that Congress did not do so (Com.Br. 20).

(2) That there was no contraction of the Pacific business enterprise because Pacific used the proceeds arising in connection with the distribution of the Northwest shares to refinance past borrowings and finance further expansion. To argue that Pacific's business was not "contracted" when its operations shrank from four states to one state simply denies the obvious. In passing, it should be noted that section 355 is not cast in terms of "contraction" of a business enterprise. As its legislative history plainly reveals, section 355 deals with the *division* of business enterprises, and the continuation of such businesses under two or more corporations instead of only one.[12]

The Commissioner's attempts to draw an analogy between these cases and the tax-avoidance case of *Gregory v. Helvering* (1935) 293 U.S. 465 (Com.Br. 21-22), are wholly unwarranted. The attempted reorganization in *Gregory* was a masquerade, a mere artifice entirely lacking in business purpose and designed solely for tax avoidance. The *Gregory* case does not even remotely resemble the situation here, involving a bona fide divisive reorganization with no possible element of tax avoidance, which the Commissioner concedes (Com.Br. 20) was adopted for legitimate corporate business purposes.

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[12]Section 355(b)(1)(A) expressly requires continuation of the active conduct of the business by all participating entities. Treasury regulations further emphasize this requirement:

> "Section 355 contemplates a continuity of the entire business enterprise under modified corporate forms * * *" (Income Tax Regs. sec. 1.355-2(c)).

As the legislative history shows, subject to restrictions on distribution of earnings and profits none of which are applicable here, Congress intended in section 355 to dispense with mechanical requirements and liberalize the law in cases involving mere rearrangements of the corporate structure.[13] Pacific's plan clearly carries out the purposes of Congress under section 355.

III

THERE IS NO MERIT IN ANY OF THE COMMISSIONER'S CONTENTIONS DIRECTED AT THE CONSTRUCTION OF SECTION 355.

A. The Commissioner is in error in contending that Pacific did not distribute "solely stock or securities" of Northwest as required by section 355(a)(1)(A).

The Commissioner's elaborate argument (Com. Br. 23-25) that the rights did not satisfy the "solely stock or securities" requirement since they were not stock or securities, may be dismissed as not relevant to the issues raised in these cases. There is no contention that the Northwest rights were either stock or securities, and none of the courts below so held.

In contending that the receipt of the rights constituted dividend income, the Commissioner first attempts to dis-

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[13]The Commissioner's cursory treatment of the changes in the divisive reorganization provisions effected by section 355 (Com. Br. 18-19) is neither complete nor accurate. The Commissioner merely states that section 355 carried forward the requirements of the 1951 Act and added several specific and detailed new requirements, substantially narrowing the class of transactions qualifying for nonrecognition (Com.Br. 19). A proper analysis of the legislative history of section 355, enumerating the many liberalizing features, is set forth in the taxpayers' brief (pp. 31-36).

tinguish *Palmer v. Commissioner* (1937) 302 U.S. 63, and then argues that in any event the *Palmer* rule no longer applies under the 1954 Code (Com. Br. 26-28, 46-47). The Commissioner rejects the widely held view that *Palmer* decided that the receipt of rights to buy portfolio shares[14] did not constitute income. He contends that *Palmer* merely decided the date to be used in determining whether the issuance of the rights resulted in income, i.e., the date of issue or the date of exercise, and that the Court's statement in *Palmer* that the mere issue of rights is not a dividend must be read in the light of the absence of a spread in *Palmer* at the time the rights were issued.

The Commissioner is in error in denying that the *Palmer* case decided the issuance of rights is not a taxable event and does not result in taxable income. This Court's review of the *Palmer* case resulted from a conflict among five courts of appeals as to whether receipt of rights resulted in taxable income or whether the exercise of rights was the taxable event. The *Palmer* case dealt with the nature of stock rights and the tax effect of their issuance and exercise. As *Choate v. Commissioner of Internal Revenue* (2 Cir. 1942) 129 F.2d 684 and other cases following *Palmer* have held, the *Palmer* case decided that the mere issuance of rights is not a

[14]The Commissioner refers to portfolio shares as the stock one corporation owns in another, but his use of this term with reference to the Northwest stock is misleading in that he suggests that the Northwest stock was an investment of Pacific. Northwest was created by Pacific immediately prior to the first rights offering for the express purpose, under Pacific's plan, of providing the corporate vehicle to receive the divided business and assets in the three northwest states, so that the stock of Northwest could be distributed to the Pacific shareholders.

dividend because thereby there is no distribution of corporate assets or diminution of the net worth of the corporation in any practical sense. The rights are mere offers and are not closed and completed transactions until either accepted by exercise or sold. No distribution of corporate property takes place until the rights are exercised.

This rule as to the time of distribution in the case of stock rights is in keeping with the general rules governing distributions of cash dividends. A distribution of a cash dividend does not take place on the declaration date or the record date, but rather on the date the dividend is payable. This rule applies whether the shareholder is on a cash basis or an accrual basis (*Avery v. Commissioner* (1934) 292 U.S. 210; *Estate of Putnam v. Comm'r* (1945) 324 U.S. 393). Despite the fact that the right to a dividend declared may be property to the shareholder, and even subject to separate transfer when the stock is selling ex-dividend, there is no distribution, i.e., no dividend, until the dividend is paid. The reason for this rule was explained in *Commissioner of Internal Rev. v. American L. & T. Co.* (7 Cir. 1946) 156 F.2d 398. A dividend must be a distribution out of earnings and profits, and the sufficiency of earnings and profits for a dividend is determined as of the date of payment and not as of the date of declaration (*Mason v. Routzahn* (1927) 275 U.S. 175).

Here there was a "spread" at the time the Northwest rights were issued, but the distribution did not occur until the rights were exercised. At that time the property distributed was the Northwest stock itself—not the rights, since the rights were extinguished upon exercise. The

Tax Court properly held that under the *Palmer* case the subject of the distribution, i.e., the corporate property transferred, was not the rights but the Northwest stock.

The Commissioner asserts that the *Palmer* rule no longer applies because of certain changes in the 1954 Code. He argues that such changes support his contention that "a distribution of transferrable [sic] rights to acquire corporate property at less than fair market value is taxable" (Com. Br. 28).[15] This argument is further elaborated in the discussion in the Commissioner's brief, pages 47 to 49 inclusive.

The Commissioner's principal reliance is on the definition of property in section 317 for purposes of dividend distributions under section 301. Property is defined as not including "stock in a corporation making the distribution (or rights to acquire such stock)." The Commissioner argues that therefore the term "property" as used in section 301 includes rights to subscribe to shares of stock of another corporation, and that the Northwest rights were property taxable at their fair market value when received (Com. Br. 28, 48). He concludes that the *Palmer* rule no longer obtains under the 1954 Code, and that rights to subscribe to "portfolio shares" are taxable distributions of corporate property as of the date issued, at their fair market value on such date. Contrary to his

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[15]It may be more proper to refer to the "issuance" of rights when rights are created, rather than "distribution" of rights, so as to take cognizance of the distinction noted in *Palmer* that the "distribution" of corporate property occurs when the rights are exercised and that there is no such "distribution" at the time the rights are issued. There may be situations where rights received by a corporation may in turn be the subject of a distribution to its shareholders (CCH Capital Changes Reporter, Explanatory Guide, par. 208.04).

novel argument, no court which has passed on the tax treatment of stock rights under the 1954 Code, including the three courts below, has considered that the Code made any change in the *Palmer* rule (e.g., *William H. Bateman* (1963) 40 T.C. 408).

The Commissioner's reliance on the definition of property in section 317(a) is misplaced.[16] The ruling in *Palmer* that the receipt of stock rights is not income did not turn on the question whether stock rights in the hands of the recipient shareholders were property. It was assumed in the *Palmer* case that they were, since even at the date of issuance the rights were valuable. In the *Palmer* case, as here, the Commissioner contended that stock rights were taxable when received on the ground that they constituted "property" for dividend purposes. The definition of a dividend in section 115(a)[17] of the 1928 Act, dealt with in *Palmer*, was just as broad as the definition of a dividend in present section 301. Nonetheless, the Court held that the rights were not dividends.

The absence of a dividend on the mere issuance of rights under *Palmer* is predicated on the nature of stock

[16]The exception clause in section 317 may readily be explained by reference to section 305(b). Under section 305(b), Congress carried over and supplemented a provision of prior law for the taxation of stock or stock rights in the same corporation if paid "in lieu of" money. The new definition of property in section 317 made desirable the clarification that while "in lieu" stock or stock rights were taxable property for purposes of section 301, stock of the distributing corporation and stock rights in such corporation were not property for such purposes, as held in *Eisner v. Macomber* (1920) 252 U.S. 189, and *Miles v. Safe Deposit Co.* (1922) 259 U.S. 247.

[17]"(a) *Definition of dividend.*—The term 'dividend' when used in this title * * * means *any distribution* made by a corporation to its shareholders, whether in money or in *other property*, out of its earnings or profits * * *" (emphasis added).

rights. The cases at bar present an even stronger situation than did *Palmer* for not treating the rights as a taxable distribution. In *Palmer,* the stock to which the rights related was a "portfolio" investment. Here, Northwest was created by Pacific, and all of its stock was held by Pacific temporarily, until the division and spin-off of Pacific could be completed. The short-term rights were part of the corporate mechanisms employed. The situation resembles *Miles v. Safe Deposit Co.* (1922) 259 U.S. 247, where stock rights to acquire more stock in the *same enterprise* were held to be no division of corporate profits or capital, but an opportunity for the shareholders to participate, in preference to strangers, in contributing additional capital to the enterprise (259 U.S. 251-252).

The 1954 Code made no change in the language of section 301 requiring a "distribution of property." The Committee Reports covering Subchapter C of the 1954 Code, dealing with corporate distributions, are devoid of any evidence that Congress intended to change the rule of the *Palmer* case and to make stock rights taxable on receipt rather than exercise. On the contrary, the House and Senate Committee Reports state that section 301 was "derived generally from," or "represented a restatement of existing law under," section 115(a), (b), (d), (e) and (j) (H.Rept. 1337, 83d Cong., 2d Sess., p. A70; S.Rept. 1622, 83d Cong., 2d Sess., p. 231).

Nothing in *Commissioner v. LoBue* (1956) 351 U.S. 243, or *Commissioner v. Smith* (1945) 324 U.S. 177, is at odds with the *Palmer* case. Those cases did not involve any question of the distribution of a dividend to a stockholder as in *Palmer.* The issue in *LoBue* and *Smith* related to

the determination of income under section 22(a) of the Internal Revenue Code of 1939 from stock options received by employees as compensation for services. The cases dealt with whether the amount of such income was measured by the spread at the date of exercise or the date of receipt. Both of these cases cited *Palmer* with approval. The contention by the Commissioner (Com. Br. 27) that employee stock options having a readily ascertainable value were treated as property in the *Smith* and *LoBue* cases does not run counter to the *Palmer* case. Like the change in the 1954 Code on the definition of property, these cases do not reach the question considered and disposed of in *Palmer* whether the issuance of stock rights was a distribution of corporate property constituting a dividend.

The tax results of the Commissioner's theory, which are not fully developed by the Commissioner, provide an excellent reason why Congress was well advised in the overhaul of the 1954 Code not to change the *Palmer* case rules. The Commissioner states that stock rights should be considered dividend income on the date issued, in the amount of their fair market value at that time. He also states that the rights would have a basis thereafter equal to such value, and that gain or loss on their subsequent sale would be measured by the difference between the sale price and such basis (Com. Br. 49). This could not be true in the case of corporate shareholders receiving rights, since section 301(b)(1)(B) expressly provides that the amount of the dividend in such case would be the lesser of the fair market value of the property received, or the basis of such property in the hands of the distributing corpora-

tion. Since a corporation issuing rights would never have a cost basis for such rights, the inevitable effect of the Commissioner's contention is that corporations exercising stock rights would never receive dividend income. Further, under the Commissioner's theory, shareholders allowing rights to lapse would have dividend income on receipt of the rights and a capital loss upon lapse.[18]

These tax effects, required by what Commissioner has termed "the technical analysis" (Com. Br. 49), may not be avoided by his suggestion that it may be "convenient" to ignore the results of his theory under the statutes and to treat the difference in time between the date of receipt and the date of sale as of no consequence. Congress has spelled out in detail in section 301 how dividends are to be taxed, and no vague, flexible rules may be improvised as a substitute for these statutory provisions.

The rule in the *Palmer* case has been well established for over 30 years, and has been so firmly entrenched in the administrative practice that not until these cases has the Commissioner contended that the *Palmer* rules governing the tax treatment of stock rights no longer apply under the 1954 Code.[19] To change these rules, which have

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[18]See Carlson, Taxation of "Taxable" Stock Rights: The Strange Persistence of *Palmer v. Commissioner*, 23 Tax L.Rev. 129, 142-143. In defense of the author, it must be conceded he refuses to apply his theories to stock rights issued as part of a reorganization, and cites an excellent discussion of the present cases approving the Second Circuit's decision (Note, 81 Harv.L.Rev. 482 (1967); see Carlson, op.cit., p. 149).

[19]G.C.M. 25063 (C.B. 1947-1, 45), which holds that stock warrants are not income when received by the shareholders under the 1939 Code, is to the same effect as the Commissioner's rulings to Pacific in these cases arising under the 1954 Code (A. 152-153, 158-159).

been so well understood by corporations and shareholders alike, and which are solidified by such a long period of established practice on the part of the Internal Revenue Service, would have wide ramifications (*American Automobile Assn. v. U. S.* (1961) 367 U.S. 687; *Commissioner v. Brown* (1965) 380 U.S. 563).

B. The Commissioner is in error in contending that Pacific did not "distribute [the Northwest stock] to a shareholder with respect to its stock."

The discussion on this aspect of the case focuses on the payment of cash by the Pacific shareholders in exercising their rights. Essentially, the Commissioner contends (1) that the transfer of the Northwest stock on such exercise was not a distribution but a sale; (2) that even if it was a distribution, it was not a distribution with respect to Pacific stock, but rather with respect to such stock and cash of $16 for each Northwest share; and (3) that it was not a distribution to the Pacific shareholders, since "anyone" could buy rights and receive Northwest stock.

The bargain purchase regulations under section 301 are sufficient authority for rejection of the Commissioner's contention that a transfer of property by a corporation to its shareholders for a cash consideration is not a distribution. These regulations are to the effect that distributions to shareholders "with respect to their stock" under section 301 include transfers of corporate property to shareholders for less than fair market value "in a sale or exchange" (Income Tax Regs. sec. 1.301-1(j)) (cf. *Lester E. Dellinger* (1959) 32 T.C. 1178, and cases there cited). The Commissioner does take note of these

regulations in his brief (Com. Br. 33). However, he makes no attempt to explain the contradiction in his argument that Pacific's distribution of Northwest stock was not "with respect to its stock" under section 355, yet resulted in a taxable dividend under section 301. Section 301 is couched in the same terms: "distribution * * * made by a corporation to a shareholder with respect to its stock."[20] Moreover, as stated in the *Palmer* case, "a sale of corporate assets to stockholders is, in a literal sense, a distribution" (302 U.S. 69).

The other arguments of the Commissioner on these points are answered in taxpayers' opening brief at pages 52-57, inclusive. The Commissioner does not explain why he would impute to Congress an intent to exclude from section 355 distributions involving the *payment* of cash *by* the shareholders, when distributions with no payment are tax-free under that section. He does not rely on the attempted justification by the Ninth Circuit that "Congress could well conclude that the prospect that the same people * * * will continue to own the same business would be undermined if a distribution was effectuated by means of transferable stock rights, the exercise of which required substantial cash payments" (A. 325-326). The Commissioner does suggest, however, that "any" persons who were not Pacific shareholders could have bought rights and therefore received Northwest stock without regard to the stock of Pacific.

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[20]As stated in a recent Harvard Law Review note on these cases, the Commissioner's gloss on section 355 excluding distributions for consideration from distributions "with respect to stock" is untenable when applied to similar language in section 301(a) (81 Harv.L.Rev. (1968) 482, 485).

The short answer to both of these suggestions is that all of the rights were issued to the Pacific shareholders and over 95 per cent of Northwest stock was obtained through the exercise of rights by Pacific shareholders. Section 355 is cast in terms of what is actually accomplished, not in terms of what might have happened.

Section 355 is invoked by taxpayers not in respect of rights sold but of rights exercised. These rights were received by them as shareholders of Pacific. As shareholders of Pacific, they exercised these rights to retain their same proportionate interest in Pacific which they had before the Northwest stock was distributed. Necessarily, the rights which they received and exercised were with respect to their Pacific stock, for they were issued only to Pacific shareholders. Each share of Northwest stock was indivisible. Each Northwest share received by taxpayers in the exercise of their rights inured to and was derived from their ownership in Pacific stock, conditioned only on the payment of $16 a share.

It makes no difference under section 355 whether the transfer of the Northwest stock and the payment of cash to Pacific are considered as two transactions or one. The Second Circuit indicated that the cash payment might be treated as a contribution of capital separately from the distribution of the Northwest stock (A. 285, 287). Whether it is so viewed, or whether it is viewed as the Tax Court did as a bargain purchase of the Northwest stock, the conclusion is in no way altered that the Northwest stock was distributed with respect to Pacific stock.

How Pacific is required to treat for its tax purposes the receipt of the cash in the exercise of rights by the

minority shareholders is beside the point. Pacific is not a party to these proceedings and certainly these taxpayers are not bound by the income tax treatment of Pacific in these transactions.

The difficulties in the computation of basis of the Pacific and Northwest stock alleged to result from the Second Circuit's analysis (Com. Br. 34) do not exist. On the contrary, the application of section 355 resolves basis difficulties encountered under the Commissioner's theory (Taxp. Br. 46, 47). For those Pacific shareholders who exercised their rights, the original cost basis of their Pacific stock and the amount paid in upon exercise of the rights must be allocated between their Pacific and Northwest stock in proportion to relative fair market value (Income Tax Regs. sec. 1.358-2(a)(2)). This accords with the realities of the situation. As for those who exercised purchased rights (Com. Br. 34, n. 11), it is clear that the cost of their Northwest shares is the amount paid for the rights plus $16 a share, since they had no Pacific stock to which any cost basis can be allocated.

The Commissioner's contention that transferability of the rights defeats the requirement of a distribution to Pacific's "shareholders," on the ground that some might sell their rights and not receive the stock, is without merit. Congress considered the possibility of transfer of the distributed stock, and declared it insufficient to defeat the applicability of the statute in the absence of prearrangement (sec. 355(a)(1)(B)). As the Second Circuit stated (A. 288), the doctrine of continuity of interest has never been used to void a reorganization on the ground

that some of the shareholders might have sold some of their stock. The court pointed out that such a rule would void each and every attempted reorganization, for with rare exceptions, stock can always be sold. Here, continuity of interest manifestly was preserved (Income Tax Regs. sec. 1.355-2(c)). The required continuity is no more than 80 per cent. Obviously that requirement is satisfied when more than 95 per cent of the Northwest stock was distributed to the Pacific shareholders who exercised their rights.[21]

The argument of the Commissioner on pages 36 and 37 of his brief is difficult to follow. Nonrecognition treatment accorded spin-offs under section 355 lies, not in the fact that such transactions would be partial liquidations taxable at capital gain rates, but rather in the fact that they represent readjustments of corporate structures which effect adjustments of continuing interests in the same business enterprise under modified corporate forms (sec. 355(b)(1)(A); Income Tax Regs. sec. 1.355-2(c)). Even accepting the Commissioner's theory that "a genuine contraction of the business" is required by the application of section 355, it is manifestly present here. The businesses conducted by Pacific in the States of Oregon, Washington and Idaho were transferred to Northwest, and thereupon Pacific withdrew from those states and no longer conducted any business therein. To say that such withdrawal is not a contraction of Pacific's original business is scarcely credible.

[21]To the same effect are the comments of the Tax Court (A. 269, n. 10).

C. The distribution of the Northwest stock through two rights offerings satisfied the requirements of section 355(a)(1)(D).

The essence of the Commissioner's contention with respect to section 355(a)(1)(D) is:

> "The language of Section 355(a)(1)(D) contemplates one and not two unconnected distributions of stock" (Com. Br. 41).

The Commissioner's distortions of the record in stating the facts relating to the two distributions of the Northwest stock are discussed ante, pp. 7-9. There is no warrant for the assertion that the 1963 offering was distinct and separate from the 1961 offering.

The Commissioner's one-distribution contention was raised for the first time in the courts of appeals. Both the Ninth Circuit and the Second Circuit rejected it. The Commissioner does not rely on the Ninth Circuit's holding that the 1963 offering was not part of the same transaction as the 1961 offering under the newly conceived test laid down by that court (A. 333). Instead, the Commissioner seeks to draw an inference from certain language of section 355 that only one distribution of stock is permitted under that section. Isolating such words and phrases as "immediately before" and "immediately after"[22] and the term "distribution," he contends that

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[22]The Commissioner can find little comfort in this language in the light of similar language used in section 351, interpreted by Income Tax Regulations section 1.351-1(a)(1)):

> "The phrase 'immediately after the exchange' does not necessarily require simultaneous exchanges by two or more persons,

section 355(a)(1)(D) requires that the stock be disposed of "in a single transaction" (Com. Br. 42).

The "immediately before" and "immediately after" phrases have a perfectly reasonable and practical application in these cases. The requirement of control "immediately before" the distribution (sec. 355(a)(1)(A)) was satisfied by the admitted fact that Pacific owned all of the Northwest stock prior to its distribution. The reorganization was a single transaction which was accomplished through the two rights offerings in 1961 and 1963. The requirement that each of the corporations be engaged in the active conduct of trade or business "immediately after" the distribution (sec. 355(b)(1)) was satisfied by the continued conduct of the separated businesses by Pacific and Northwest respectively. The requirement of active conduct of the businesses "throughout the 5-year period ending on the date of the distribution" (sec. 355(b)(2)(B)) was satisfied by Pacific's continuous conduct of the business for many decades prior to the reorganization.

As the Second Circuit held, nothing on the face of the statute relates to the number of transactions or their timing which may be contained in a distribution (A. 291). More importantly, the result urged by the Commissioner, as pointed out by the Second Circuit, would be incongruous

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but comprehends a situation where the rights of the parties have been previously defined and the execution of the agreement proceeds with an expedition consistent with orderly procedure."

To like effect see Income Tax Regulations section 1.368-2(c), interpreting the phrase "immediately after the acquisition" in section 368(a)(1)(B) as permitting a series of acquisitions.

in the light of the nature of the transactions covered by section 355. A section 355 transaction which involves a transfer of assets to a new corporation controlled by the transferor, such as occurred here, qualifies literally as a reorganization under section 368(a)(1)(D). The Code does not require a single distribution for that or any other of the tax-free reorganizations defined in section 368. Such a requirement for divisive reorganizations under section 355 cannot be read into the Code without a substantial reason (A. 293).

The reasons advanced by the Commissioner have no support. He first suggests that when Congress intended that the tax consequences of a transaction be determined by examining events occurring in more than one year, it has said so explicitly. While this may be true in the instances cited (Com. Br. 42), it is not a universal rule. Where the tax consequences of a transaction depend on whether a reorganization has occurred, it is frequently necessary to examine events occurring in more than one taxable year. It is well settled in reorganization cases that steps not confined to a single taxable year, but which are integrated parts of a single plan, must be examined to determine whether or not all of the steps constitute a reorganization. This is a rule that has been invoked as much by the Commissioner to prevent tax avoidance as it has by taxpayers to obtain nonrecognition of gain (*Moffatt v. C.I.R.*, supra, 363 F.2d 262).

There is no merit in the Commissioner's suggestion that periodic distributions of Northwest stock could have been made as substitutes for dividend distributions. The speculation that Pacific could have distributed one tenth

of the Northwest stock in each of ten successive years is fully met by the Second Circuit's statement (A. 294):

> "But that is not our case and it can scarcely be contested that the Code imposes a tax on facts, not expectations."

The record establishes that successive offerings of the Northwest stock as a substitute for dividends were not even possible under the plan. As must be conceded by the Commissioner, Pacific at no time retained any of the Northwest stock for any tax-avoidance purpose.

The 1961 and 1963 offerings were parts of the same transaction, as found by the Tax Court (A. 255, n. 4). Through these offerings, Pacific distributed all of the Northwest stock. Section 355(a)(1)(D) requires no more.

IV

THE SALE OF THE RIGHTS BY TAXPAYERS IN NO. 760 GAVE RISE TO CAPITAL GAIN AND NOT DIVIDEND INCOME.

The Commissioner's discussion of this issue develops a new theory of the tax treatment of stock rights. He rejects the rule of the *Palmer* case that the receipt of rights does not constitute income (Com. Br. 46-49). Instead the Commissioner contends that the *Palmer* rule is no longer applicable under the 1954 Code, and that under section 301, the Northwest rights must be treated as dividend income at their fair market value at the time of receipt (Com. Br. 49). The Commissioner then asserts that, while the technical analysis of the situation requires this result, "it is convenient" where rights are sold "to

minimize the amount of computation involved, and to treat the proceeds on sale as being the dividend, rather than the fair market value on the date of the receipt of the rights" (Com. Br. 49).[23] This cavalier approach has no support in the law. Congress has spelled out in section 301 how the amount of dividends is to be determined, and no rules to the contrary can be improvised as a substitute for the explicit statutory requirements.

The sale of the rights by taxpayers in No. 760 was an anticipatory realization on the Northwest stock that would have been received had the rights been exercised (*Helvering v. Horst* (1940) 311 U.S. 112). As the Second Circuit held, the nature of the distribution of Northwest stock, under section 355, was capital, and therefore the sale of the rights should give rise to a capital gain or loss (A. 296).

Regardless of whether the transaction qualifies under section 355, the rights sold by the taxpayers represented a portion of their equity and capital investment in Pacific which had been transferred to Northwest (Taxp. Br. 71-72). In disposing of the rights, they sold a portion of their equity, and this sale should be accorded capital gain treatment.

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[23]The Commissioner overlooks the provisions of section 301(b)(1)(B), requiring that corporate shareholders receiving a dividend in property are required to treat as the amount of the dividend the *lesser* of the fair market value of the property received or the basis of such property in the hands of the distributing corporation, ante, p. 7. Rights issued by a corporation could never have a cost basis in the hands of the issuing corporation. Under no circumstances could the Commissioner's theory be applied to corporate shareholders, for in all cases the measure of the dividend would be the zero basis rather than fair market value.

The taxpayers made an alternative contention in the courts below that the distribution of the Northwest stock should be treated as a distribution in partial liquidation of Pacific under section 346, in the event it was held section 355 did not apply. The Tax Court found it unnecessary to consider this alternative contention, and the Ninth Circuit, in reversing the Tax Court, remanded the case to permit its consideration. Under the taxpayers' alternative contention, even if it should be held that section 355 did not apply to exercise of the rights, the sale of the rights was a sale of the taxpayers' interest in a distribution in partial liquidation of Pacific under section 346, and a capital transaction, not under any circumstances an ordinary dividend taxable under section 301.

CONCLUSION

The judgment of the Court of Appeals for the Second Circuit in No. 760 should be affirmed, and the judgment of the Court of Appeals for the Ninth Circuit in No. 781 should be reversed with directions to affirm the Tax Court.

Respectfully submitted,

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SUPREME COURT OF THE UNITED STATES

Nos. 760 AND 781.—OCTOBER TERM, 1967.

Commissioner of Internal Revenue, Petitioner, 760 *v.* Irving Gordon et ux.	On Writ of Certiorari to the United States Court of Appeals for the Second Circuit.
Oscar E. Baan et ux., Petitioners, 781 *v.* Commissioner of Internal Revenue.	On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

[May 20, 1968.]

MR. JUSTICE HARLAN delivered the opinion of the Court.

These cases, involving the interpretation of § 355 of the Internal Revenue Code of 1954, have an appropriately complex history.

American Telephone and Telegraph Company (hereafter A. T. & T.) conducts its local communications business through corporate subsidiaries. Prior to July 1, 1961, communications services in California, Oregon, Washington, and Idaho were provided by Pacific Telephone and Telegraph Company (hereafter Pacific). A. T. & T. held about 90% of the common stock of Pacific at all relevant times. The remainder was widely distributed.

Early in 1961, it was decided to divide Pacific into two separate corporate subsidiaries of A. T. & T. The plan was to create a new corporation, Pacific Northwest Bell Telephone Company (hereafter Northwest) to conduct telephone business in Oregon, Washington, and Idaho, leaving the conduct of the California business in the hands of Pacific. To this end, Pacific would transfer

all its assets and liabilities in the first three States to Northwest, in return for Northwest common stock and debt paper. Then, Pacific would transfer sufficient Northwest stock to Pacific shareholders to pass control of Northwest to the parent company, A. T. & T.

Pacific had, however, objectives other than fission. It wanted to generate cash to pay off existing liabilities and meet needs for capital, but not to have excess cash left over. It also feared that a simple distribution of the Northwest stock would encounter obstacles under California corporation law.[1] Consequently, the "Plan for Reorganization" submitted to Pacific's shareholders on February 27, 1961, had two special features. It provided that only about 56% of the Northwest common stock would be offered to Pacific shareholders immediately after the creation of Northwest. It also provided that, instead of simply distributing Northwest stock pro rata to shareholders, Pacific would distribute to its shareholders transferable rights entitling their holders to purchase Northwest common from Pacific at an amount to be specified by Pacific's Board of Directors, but expected to be below the fair market value of the Northwest common.

In its February 27 statement to shareholders, Pacific said that it was seeking a ruling from the Internal Revenue Service

> "with respect to the tax status of the rights to purchase which will be issued in connection with the

[1] The record indicates that Pacific's attorneys had advised that if Pacific distributed the Northwest shares without payment of consideration by Pacific's shareholders, the distribution would have to be charged to earned surplus; the attorneys further advised that Pacific had insufficient earned surplus for this purpose, and that if this difficulty were avoided by creation of a reduction surplus, the reduction surplus would, under California law, have to be used first to redeem Pacific's preferred shares.

> offerings of capital stock of the New Company to shareholders of the Company . . . ."

The statement warned, however, that "[t]axable income to the holders of such shares may result with respect to such rights."

The plan was approved by Pacific's shareholders on March 24, 1961. Pacific transferred its assets and liabilities in Oregon, Washington, and Idaho to Northwest, and ceased business in those States on June 30, 1961. On September 29, 1961, Pacific issued to its common stockholders one right for each outstanding share of Pacific stock. These rights were exercisable until October 20, 1961. Six rights plus a payment of $16 were required to purchase one share of Northwest common. The rights issued in 1961 were sufficient to transfer some 57.3% of the Northwest stock.

By September 29, 1961, the Internal Revenue Service had ruled that shareholders who sold rights would realize ordinary income in the amount of the sales price, and that shareholders who exercised rights would realize ordinary income in the amount of the difference between $16 paid in and the fair market value, measured as of the date of exercise, of the Northwest common received. The prospectus accompanying the distributed rights informed Pacific shareholders of this ruling.

On June 12, 1963, the remaining 43% of the Northwest stock was offered to Pacific shareholders. This second offering was structured much as the first had been, except that eight rights plus $16 were required to purchase one share of Northwest.

The Gordons, respondents in No. 760, and the Baans, petitioners in No. 781, were minority shareholders of Pacific as of September 29, 1961. In the rights distribution that occurred that day the Gordons received 1,540 rights under the plan. They exercised 1,536 of the rights

on October 5, 1961, paying $4,096 to obtain 256 shares of Northwest, at a price of $16 plus six rights per share. The average price of Northwest stock on the American Stock Exchange was $26 per share on October 5. On the same day, the Gordons sold the four odd rights for $6.36. The Baans received 600 rights on September 29, 1961. They exercised them all on October 11, 1961, receiving 100 shares of Northwest in return for their 600 rights and $1,600. On October 11, the agreed fair market value of one Northwest share was $26.94

In their federal income tax returns for 1961, neither the Gordons nor the Baans reported any income upon the receipt of the rights or upon exercising them to obtain Northwest stock at less than its fair market value. The Gordons also did not report any income on the sale of the four rights. The Commissioner asserted deficiencies against both sets of taxpayers. He contended, in a joint proceeding in the Tax Court, that taxpayers received ordinary income in the amount of the difference between the sum they paid in exercising their rights and the fair market value of the Northwest stock received. He contended further that the Gordons realized ordinary income in the amount of $6.36, the sales price, upon the sale of their four odd rights.

The Tax Court upheld taxpayers' contention that the 1961 distribution of Northwest stock met the requirements of § 355 of the code, with the result that no gain or loss should be recognized on the receipt by them or their exercise of the rights. The Tax Court held, however, that the Gordons' sale of the four odd rights resulted in ordinary income to them. The Commissioner appealed the *Baan* case to the Court of Appeals for the Ninth Circuit, and the *Gordon* case to the Court of Appeals for the Second Circuit; in the latter, the Gordons cross-appealed. The Ninth Circuit reversed the Tax

Court, holding that the spread between $16 and fair market value was taxable as ordinary income to the Baans. The Second Circuit disagreed, sustaining the Tax Court on this point in the *Gordon* case. The Second Circuit went on to hold that the amount received by the Gordons for the four odd rights was taxable as a capital gain rather than as ordinary income, reversing the Tax Court on this point.

Because of the conflict, we granted certiorari. 389 U. S. 1033, 1034. We affirm the decision of the Court of Appeals for the Ninth Circuit, and reverse the decision of the Court of Appeals for the Second Circuit on both points.

Under §§ 301 and 316 of the code, subject to specific exceptions and qualifications provided in the code, any distribution of property by a corporation to its shareholders out of accumulated earnings and profits is a dividend taxable to the shareholders as ordinary income.[2] Every distribution of corporate property, again except as otherwise specifically provided, "is made out of earnings and profits to the extent thereof."[3] It is here agreed

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[2] Section 301 (a) provides as follows:

"Except as otherwise provided in this chapter, a distribution of property (as defined in section 317 (a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c)."

Section 317 (a) provides that "the term 'property' means money, securities, and any other property . . . ." Section 301 (c) provides that the "portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income." Section 316 says that "the term 'dividend' means any distribution of property made by a corporation to its shareholders—(1) out of its earnings and profits accumulated after February 28, 1913, or . . . ."

[3] Section 316 (a) provides in part as follows:

"Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof . . . ."

that on September 28, 1961, Pacific's accumulated earnings and profits were larger in extent than the total amount the Commissioner here contends was a dividend—the difference between the fair market value of all Northwest stock sold in 1961 and the total amount, at $16 per share, paid in by purchasers.

Whether the actual dividend occurs at the moment when valuable rights are distributed or at the moment when their value is realized through sale or exercise, it is clear that when a corporation sells corporate property to stockholders or their assignees at less than its fair market value, thus diminishing the net worth of the corporation, it is engaging in a "distribution of property" as that term is used in § 316.[4] Such a sale thus results in a dividend to shareholders unless some specific exception or qualification applies. In particular, it is here agreed that the spread was taxable to the present taxpayers

[4] See, *e. g., Choate* v. *Commissioner,* 129 F. 2d 684 (C. A. 2d Cir.). In *Palmer* v. *Commissioner,* 302 U. S. 63, this Court said,

"While a sale of corporate assets to stockholders is, in a literal sense, a distribution of its property, such a transaction does not necessarily fall within the statutory definition of a dividend. For a sale to stockholders may not result in any diminution of its net worth and in that case cannot result in any distribution of its profits.

"On the other hand such a sale, if for substantially less than the value of the property sold, may be as effective a means of distributing profits among stockholders as the formal declaration of a dividend."

In *Palmer,* rights were distributed entitling shareholders to purchase from the corporation shares of stock in another corporation. Finding that the sales price represented the reasonable value of the shares at the time the corporation committed itself to sell them, this Court found no dividend. It held that the mere issue of rights was not a dividend. It has not, however, been authoritatively settled whether an issue of rights to purchase at less than fair market value itself constitutes a dividend, or the dividend occurs only on the actual purchase. In the present case this need not be decided.

unless the distribution of Northwest stock by Pacific met the requirements for nonrecognition stated in § 355, or § 354, or § 346 (b) of the code.[5] Since the Tax Court concluded that the requirements of § 355 had been met, it did not reach taxpayers' alternative contentions. Under the disposition that we make here upon the § 355 question, these alternative contentions remain open for further proceedings in the Tax Court.

Section 355 provides that certain distributions of securities of corporations controlled by the distributing corporation do not result in recognized gain or loss to

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[5] It is important to begin from this premise. In our view, the Court of Appeals for the Second Circuit erred in its approach to the § 355 problem because it assumed, at the outset, that the Commissioner essentially sought to tax a transaction that brought no "income" to Pacific shareholders. Whether the shareholders received income, however, cannot in practice be determined in the abstract, before looking at § 355.

Any common shareholders in some sense "owns" a fraction of the assets of the corporation in which he holds stock, including those assets that reflect accumulated corporate earnings. Earnings are not taxed to the shareholder when they accrue to the corporation, but instead when they are passed to shareholders individually through dividends. Consequently it does not help to note, as the Second Circuit here did, that the distribution of Northwest stock merely changed the form of ownership that Pacific's shareholders enjoyed and did not increase their wealth. This is only very roughly true at best, but in the rough sense in which it is here true, it is true of any dividend. The question is not whether a shareholder ends up with "more" but whether the change in the form of his ownership represents a transfer to him, by the corporation, of assets reflecting its accumulated earnings and profits.

There may be a genuine theoretical difference between a change in form representing a mere corporate fission, separating what the shareholder owns into two smaller but essentially similar parts, and a change in form representing a dividend, separating what a shareholder owns *qua* shareholder from what he owns as an individual. This difference, however, must be defined by objectively workable tests, such as Congress supplied in § 355. Neither the Second Circuit nor the taxpayers have suggested any other way of identifying a true fission.

the distributee shareholders.[6] The requirements of the section are detailed and specific, and must be applied with precision. It is no doubt true, as the Second Circuit emphasized, that the general purpose of the section was to distinguish corporate fission from the distribution of earnings and profits. However, although a court may have reference to this purpose when there is a genuine question as to the meaning of one of the requirements Congress has imposed, a court is not free to disregard

[6] Sec. 355. Distribution of stock and securities of a controlled corporation.

(a) Effect on distributees.—

(1) General rule. If—

(A) a corporation (referred to in this section as the "distributing corporation")

(i) distributes to a shareholder, with respect to its stock, or

(ii) distributes to a security holder, in exchange for its securities, solely stock or securities of a corporation (referred to in this section as "controlled corporation") which it controls immediately before the distribution,

(B) the transaction was not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both (but the mere fact that subsequent to the distribution stock or securities in one or more of such corporations are sold or exchanged by all or some of the distributees (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device),

(C) the requirements of subsection (b) (relating to active business) are satisfied, and

(D) as part of the distribution, the distributing corporation distributes—

(i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or

(ii) an amount of stock in the controlled corporation constituting control within the meaning of section 368 (c), and it is established to the satisfaction of the Secretary or his delegate that the retention by the distributing corporation of stock (or stock and securities)

requirements simply because it considers them redundant, or unsuited to achieving the general purpose in a particular case. Congress has abundant power to pro-

in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax, then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder or security holder on the receipts of such stock or securities.

(2) Non pro rata distributions, etc. Paragraph (1) shall be applied without regard to the following:

(A) whether or not the distribution is pro rata with respect to all of the shareholders of the distributing corporation,

(B) whether or not the shareholder surrenders stock in the distributing corporation, and

(C) whether or not the distribution is in pursuance of a plan of reorganization (within the meaning of section 368 (a)(1)(D)).

(3) Limitation. Paragraph (1) shall not apply if—

(A) the principal amount of the securities in the controlled corporation which are received exceeds the principal amount of the securities which are surrendered in connection with such distribution, or

(B) securities in the controlled corporation are received and no securities are surrendered in connection with such distribution.

For purposes of this section (other than paragraph (1)(D) of this subsection) and so much of section 356 as relates to this section, stock of a controlled corporation acquired by the distributing corporation by reason of any transaction which occurs within 5 years of the distribution of such stock and in which gain or loss was recognized in whole or in part, shall not be treated as stock of such controlled corporation, but as other property.

(4) Cross reference.

For treatment of the distribution if any property is received which is not permitted to be received under this subsection (including an excess principal amount of securities received over securities surrendered), see section 356.

(b) Requirements as to active business.

(1) In general. Subsection (a) shall apply only if either—

(A) the distributing corporation, and the controlled corporation (or, if stock of more than one controlled corporation is distributed,

vide that a corporation wishing to spin off a subsidiary must, however, bona fide its intentions, conform the details of a distribution to a particular set of rules.

The Commissioner contends that the 1961 distribution of Northwest stock failed to qualify under § 355 in several respects.[7] We need, however, reach only one. Sec-

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each of such corporations), is engaged immediately after the distribution in the active conduct of a trade or business, or

(B) immediately before the distribution, the distributing corporation had no assets other than stock or securities in the controlled corporations and each of the controlled corporations is engaged immediately after the distribution in the active conduct of a trade or business.

(2) Definition. For purposes of paragraph (1), a corporation shall be treated as engaged in the active conduct of a trade or business if and only if—

(A) it is engaged in the active conduct of a trade or business, or substantially all of its assets consist of stock and securities of a corporation controlled by it (immediately after the distribution) which is so engaged,

(B) such trade or business has been actively conducted throughout the 5-year period ending on the date of the distribution.

(C) such trade or business was not acquired within the period described in subparagraph (B) in a transaction in which gain or loss was recognized in whole or in part, and

(D) control of a corporation which (at the times of acquisition of control) was conducting such trade or business—

(i) was not acquired directly (or through one or more corporations) by another corporation within the period described in subparagraph (B), or

(ii) was so acquired by another corporation within such period, but such control was so acquired only by reason of transactions in which gain or loss was not recognized in whole or in part, or only by reason of such transactions combined with acquisitions before the beginning of such period.

[7] The Commissioner contends, first, that Pacific did not distribute "solely stock or securities" as required by § 355 (a)(1)(A), because it distributed rights rather than stock. He contends, second, that Pacific did not distribute the Northwest stock "to a shareholder, with respect to its stock" as required by § 355 (a)(1)(A)(i), be-

tion 355 (a)(1)(D) requires that, in order to qualify for nonrecognition of gain or loss to shareholders, the distribution must be such that

> "as part of the distribution, the distributing corporation distributes—
>
> "(i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or
>
> "(ii) an amount of stock in the controlled corporation constituting control within the meaning of section 368 (c), and . . . ."

Section 368 (c) provides in relevant part that

> "the term 'control' means the ownership of stock possessing at leat 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.[8]

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cause it did not distribute the stock to shareholders but sold it to holders of transferable rights, for cash consideration. He contends, third, that Northwest did not meet the quantity requirements of § 355 (a)(1)(D) because it parted with only 57% of the stock in 1961.

Any one of these arguments, if established, would support the result the Commissioner seeks. The Court of Appeals for the Second Circuit perforce rejected all three. The Court of Appeals for the Ninth Circuit accepted all three. We reach only the last.

[8] In the Tax Court, the Commissioner did not argue that Pacific had failed to meet the requirement that it distribute at least 80% of the Northwest stock, but rested upon his other arguments against applying § 355. When the Tax Court rejected these arguments, the Commissioner raised the 80% question, as well as his other arguments in both Courts of Appeals. Both considered the point on the merits, dividing on it as on the others. Since the general issue of the applicability of § 355 has been in the case since its inception, taxpayers do not contend that the 80% question is not properly before this Court. Since the record leaves no disputed issue of fact with respect to this question, we find it proper to decide it here without reference to a tryer of fact.

On September 28, 1961, the day before the first rights distribution, Pacific owned all of the common stock of Northwest, the only class of securities that company had issued. The 1961 rights offering contemplated transferring, and succeeded in transferring, about 57% of the Northwest common to Pacific shareholders. It therefore could not be clearer that this 1961 distribution did not transfer "all" of the stock of Northwest held by Pacific prior to it, and did not transfer "control" as that term is defined in § 368 (c).

Nevertheless, taxpayers contend, and the Second Circuit agreed, that the requirements of subsection (a)(1)(D) were here met because Pacific distributed the remaining 43% of the Northwest stock in 1963. The court said that the purpose of the subsection "in no way requires a single distribution." [9] The court apparently concluded that so long as it appears, at the time the issue arises, that the parent corporation has in fact distributed all of the stock of the subsidiary, the requirements of § (a)(1)(D)(i) have been satisfied.

We are forced to disagree. The code requires that "the distribution" divest the controlling corporation of all of, or 80% control of, the controlled corporation. Clearly, if an initial transfer of less than a controlling interest in the controlled corporation is to be treated for tax purposes as a mere first step in the divestiture of control, it must at least be identifiable as such at the time it is made. Absent other specific directions from Congress, code provisions must be interpreted so as to conform to the basic premise of annual tax accounting.[10] It would be wholly inconsistent with this premise to hold that the essential character of a transaction, and its tax impact, should remain not only undeterminable but unfixed for an indefinite and unlimited period in the future,

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[9] 382 F. 2d 499, at 507.

[10] See *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359, 363–365.

awaiting events that might or might not happen. This requirement that the character of a transaction be determinable does not mean that the entire divestiture must necessarily occur within a single tax year. It does, however, mean that if one transaction is to be characterized as a "first step" there must be a binding commitment to take the later steps.[11]

Here, it was little more than a fortuity that, by the time suit was brought alleging a deficiency in taxpayers' 1961 returns, Pacific had distributed the remainder of the stock. The plan for reorganization submitted to shareholders in 1961 promised that 56% of that stock would be distributed immediately. The plan went on,

> "It is expected that within about three years after acquiring the stock of the New Company, the Company by one or more offerings will offer for sale the balance of such stock, following the procedures described in the preceding paragraph. The proceeds from such sales will be used by the Company to repay advances then outstanding and for general corporate purposes including expenditures for extensions, additions and improvements to its telephone plant.

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[11] The Commissioner contends that a multistep divestiture presents special problems in preventing bailouts of earnings and profits. The Second Circuit, recognizing such potential problems, held that they can be dealt with under § (a)(1)(B), which provides that nonrecognition shall result only when it appears that

"the transaction was not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both . . . ."

Congress may, of course, have chosen not to leave problems created by multistep divestitures to specific adjudication under this "device" subsection, but to require *both* a unitary divestiture *and* satisfaction of the "device" requirement. Whether § (a)(1)(D) would prohibit or limit a divestiture of control committed from the outset but spread over a series of steps is a problem we need not reach.

> "The prices at which the shares of the New Company will be offered pursuant to the offerings referred to . . . will be determined by the Board of Directors of the Company at the time of each offering."

It was further stated that such subsequent distributions would occur "[a]t a time or times related to its [Pacific's] need for new capital." Although there is other language in the plan that might be interpreted to prevent Pacific management from dealing with the Northwest stock in any way inconsistent with eventual sale to Pacific shareholders, there is obviously no promise to sell any particular amount of stock, at any particular time, at any particular price. If the 1961 distribution played a part in what later proved to be a total divestiture of the Northwest stock, it was not, in 1961, either a total divestiture or a step in a plan of total divestiture.

Accordingly, we hold that the taxpayers, having exercised rights to purchase shares of Northwest from Pacific in 1961, must recognize ordinary income in that year in the amount of the difference between $16 per share and the fair market value of a share of Northwest common at the moment the rights were exercised.

The second question presented by the petition in No. 760, whether the $6.36 received by taxpayers Gordon upon the sale of four rights was taxable as ordinary income, as a capital gain, or not at all, does not require extended discussion in light of our view upon the first question. Since receipt and exercise of the rights would have produced ordinary income, receipt and sale of the rights, constituting merely an alternative route to realization, also produced income taxable at ordinary rates. *Helvering* v. *Horst,* 311 U. S. 112; *Gibson* v. *Commissioner*, 133 F. 2d 308.

The judgment of the Court of Appeals for the Second Circuit is reversed. The judgment of the Court of Appeals for the Ninth Circuit is affirmed.

It is so ordered.

MR. JUSTICE MARSHALL took no part in the consideration or decision of these cases.